EXHIBITS

INTERIM REPORT NO. 3

REGARDING VIOLATIONS

OF STATE AND LOCAL LAWS AS

RELATED TO THE SDCERS PENSION FUND

REPORT OF THE

SAN DIEGO CITY ATTORNEY

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THE CITY ATTORNEY
CITY OF SAN DIEGO

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8 APRIL 2005

EXHIBIT 1

back of this volume.

A History of Public Sector Pensions in the United States

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Pension Research Council
The Wharton School of the University of Pennsylvania

PENN

University of Pennsylvania Press
Philadelphia

The U.S. military pension plans examined in this volume were all defined benefit plans, as were most of the early state and local plans. The initial reliance on defined benefit plans reflects the work and retirement incentives associated with these plans and the limited financial markets that existed during much of the nineteenth century.

Defined Benefit Plans

Today, most defined benefit plans specify a retirement benefit based on years of service with the organization and the worker's final average annual earnings during the last three or five years on the job. Some collectively bargained plans base benefits solely on years of service. Workers must remain with the organization for a sufficient period of time, typically five years, to become vested in the pension plan. Once vested, the worker has a legal claim on future retirement benefits and is entitled to a benefit at the retirement age specified in the plan.[2] This means that the worker can leave the firm prior to the specified retirement age and still receive a benefit in the future.

Most of the early public plans specified a retirement benefit based on the position or rank of the individual. Benefits were usually specified in terms of percentage of monthly pay. In order to receive a retirement benefit, the individual had to remain with the organization for many years, typically 20 to 25 years but often longer. Leaving prior to that time meant that the employee would not receive any benefits. The lack of vesting in these early plans provided a strong incentive for workers to remain on the job until they reached the age of retirement. Since discharged workers could not expect to receive any pension benefits, these plans also provided additional motivation for workers to perform at a high level so they would not be fired. Of course, there were some moral hazards built into the employer's side of these contracts, since employers had an incentive to dismiss workers as they approached retirement age and thus became eligible for pension benefits.

Employer-provided pension plans are a significant component of total employee compensation for covered workers. As such, the value of these plans helps employers to attract high-quality new workers. In addition, workers who have low discount rates will place a higher value on the promise of retirement benefits, and employees who are otherwise more likely to remain with the firm for longer periods of time will place a higher value on the pension plan (Ippolito 1997). Thus, employers can use pension plans to help sort workers based on their propensity to remain on the job. Companies that have relatively high costs of hiring and training workers will want to minimize turnover. These companies are more likely to establish retirement plans that provide incentives for workers to remain

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A simple numerical example can illustrate this point. Suppose a worker is considering two job offers. The first pays only a monthly salary of $1,000 while the second offers a salary of $950 per month plus a pension plan of $250 per month conditional on the worker remaining with the firm for 20 years. These two compensation policies are depicted in Figure 2.1. The present value of this future benefit depends on the interest and discount rates and the probability that the individual remains with the firm until retirement. Workers expecting to leave the firm after only a few years will prefer the first job while workers who expect to remain with the firm for at least 20 years will be more likely to consider accepting the second job offer. By deferring a part of labor compensation, the firm is less likely to attract workers with high probabilities of turnover and more likely to hire individuals who are willing to remain with the firm for a long period of time.

Once employed, workers evaluate the gain from remaining on the job versus moving to another employer or retiring. A key aspect of total compensation is the change in the present value of expected retirement benefits from working an additional year. This is called the benefit accrual. In a legal sense, accruals are zero until the individual becomes vested in the pension; that is, a worker who quits or is fired for nonperformance will not receive any benefit unless he has worked the minimum amount of time required for vesting. Once having been employed for the minimum number of years required to be eligible for a benefit, the worker can leave the firm and ultimately receive a pension. This pension will typically become larger the longer the person stays with the company. These benefit accruals represent a component of annual compensation and are an incentive for the worker to remain with the firm (Ippolito 1985; Kotlikoff and Wise 1989).

Workers may look ahead to the promise of future benefits and calculate the gain in those benefits conditional on remaining with the organization. One of the innovations of modern pension economics was to place these pension expectations within the context of implicit long-term employment contracts (Lazear 1979; Ippolito 1985). These models assume workers can calculate the value of future retirement benefits if they remain with the firm and the value if they quit. Again, this "quit" pension is zero if the worker is not vested. The difference between the pension conditional on remaining with the organization and the pension if the worker quits is the loss in pension wealth associated with changing jobs. The bigger this difference, the less likely workers are to quit (Allen, Clark, and McDermed 1993; Ippolito 1987; Mitchell 1982). For example, a study of federal workers in the last quarter of the twentieth century concludes that the very low turnover rate among federal employees is, at least partly, due to the unusually large pension penalties for leaving the civil service before the age of early retirement (Ippolito 1987).

Once again, a simple example can illustrate the importance of the pension incentive. Assume that a worker earns $20,000 during the first 20 years

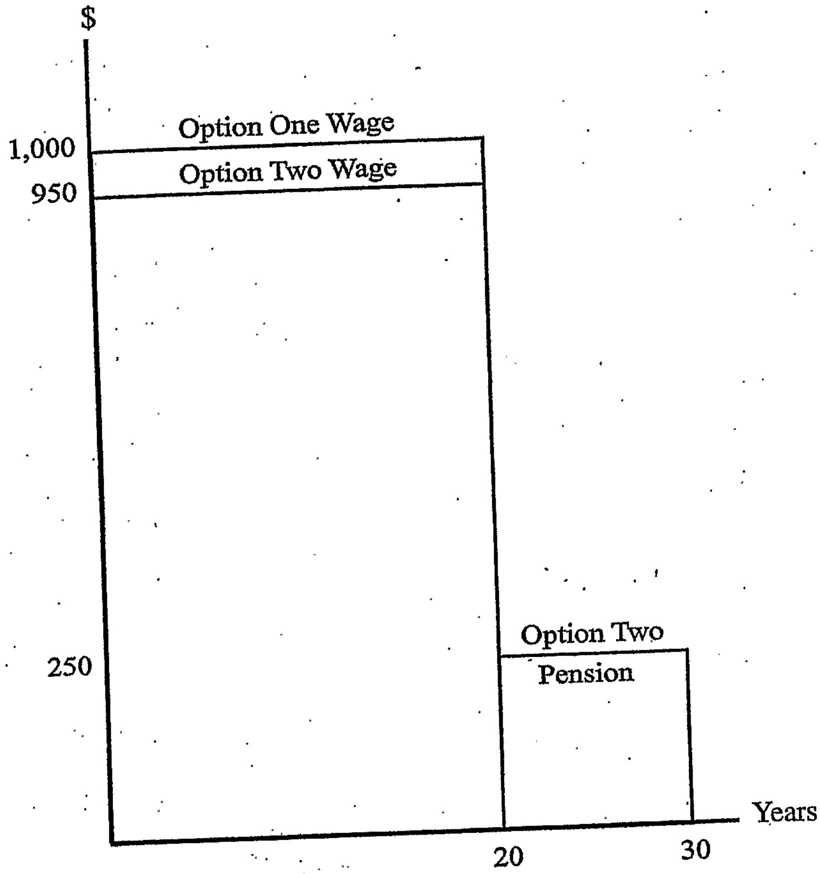

Figure 2.1. Compensation profiles with and without a pension. Two potential earnings profiles illustrate how a firm can use the promise of a pension to reduce turnover. The analysis is based on a 20-year worklife followed by 10 years in retirement, with an interest rate of 3 percent. Compensation option 1 provides a wage of $1000 per month; the present value of working for 20 years is $178,800. Obviously, any worker expecting to leave the firm with less than 20 years of service would prefer option 1.

Option 2 provides $950 per month plus a pension of $250 per month conditional on the worker remaining with the firm for 20 years. The worker gives up $50 per month in exchange for a retirement annuity of $250. The present value of $50 per month for 20 years is $8,940; the present value (at the hire date) of $250 per month commencing after 20 years and lasting for 10 years is $14,177. Thus under option 2 the present value of total compensation is $184,037.

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of her working career and $40,000 over the last 20 years of work. Further assume that her annual earnings will not be affected by changing jobs and all employers offer a defined benefit plan that provides a benefit that is equal to one percent of average earnings over the last five years of employment. A worker who spends all 40 years working for a single firm will have a retirement benefit of $16,000 per year—that is, 40 years of service times $40,000 per year in average earnings times 0.01. This last figure, 0.01, is sometimes referred to as the "generosity factor."

If she changes jobs after 20 years of employment, she will receive two pensions, one from each firm that employed her for 20 years. The pension from the first job would be $4,000 (20 years of service times $20,000 times 0.01) and the pension from the second job would be $8,000 (20 years of service times $40,000 times 0.01). Thus, her total pension would be $12,000. This example, which is depicted in Figure 2.2, shows that when earnings are unaffected by a job change and all companies have identical pension plans, a job change can have a significant impact on retirement benefits. It is this potential for loss in the lifetime values of pensions that reduces turnover among pension participants, holding other things constant, of course.

Both the gain in future benefits from continued employment and the loss in pension benefits associated with leaving influence worker behavior. These pension characteristics affect individual decisions concerning which job to accept and, once employed, whether to remain with the organization or seek new employment. Employers can alter the magnitude of these incentives by adopting certain pension provisions. In jobs with high training costs and other turnover costs, employers will want to have lower quit rates. Instituting a pension plan and selecting pension provisions that provide for higher benefit accruals and large losses in benefits if the worker leaves should result in a lower quit rate.

Pensions can also be used to motivate workers to perform at a higher level and to prevent shirking on the job (Becker and Stigler 1974; Lazear 1979). If, for example, a worker is caught shirking, is found to have stolen from the employer, or has a high absence rate, he could be discharged and thus lose retirement benefits. Thus, the same incentives that encourage workers not to quit will provide an incentive to perform at a high level to avoid discharge (Dorsey 1995). Therefore, we would expect lower quit and layoff (discharge) rates in organizations that have adopted defined benefit pension plans, a finding confirmed by much research (Allen, Clark, and McDermed 1993; Cornwell, Dorsey, and Mehrzad 1991; Lazear and Moore 1988). Since firms with lower turnover rates can afford to invest more heavily in the human capital of their employees, ceteris paribus, we would expect to see these firms pay higher wages, which is what one finds in practice (Becker 1964; Dorsey and Macpherson 1997; Dorsey, Cornwell, and Macpherson 1998).

Defined benefit pensions can also alter the incentive to retire at particular ages by providing income to those who have retired and by altering the annual benefit accrual. Today's pensions, as well as many of those in the past, sharply reduce the benefit accrual once the individual has reached the age of eligibility to begin receiving a benefit. Virtually all modern pensions specify both an early and a normal retirement age. The normal retirement age is the age at which workers can retire and receive a benefit based on the regular benefit formula; this is called an "unreduced" benefit. The early retirement age is the earliest age at which a person can receive a benefit.

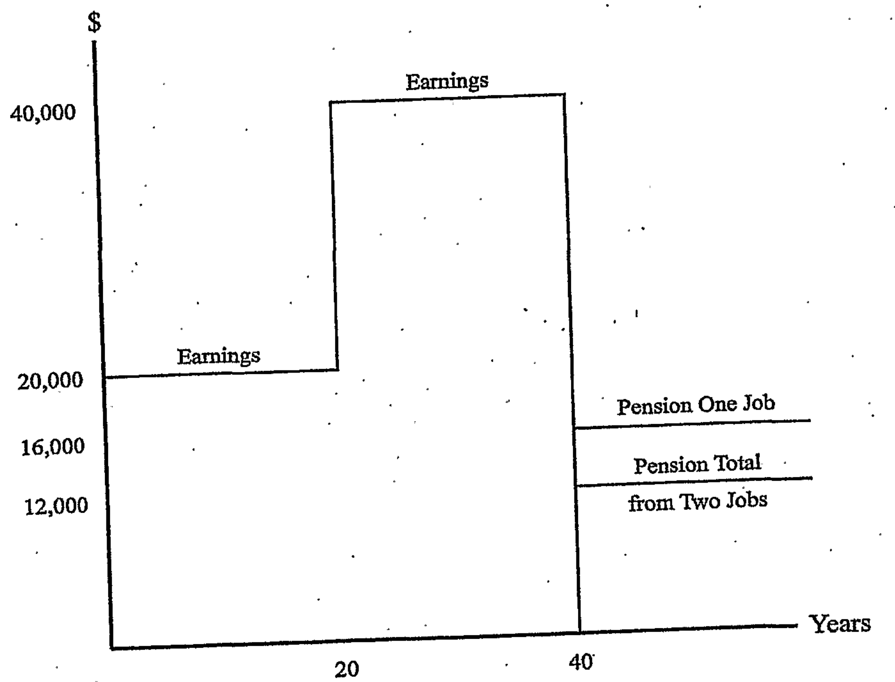


Figure 2.2. Impact of changing jobs on pension benefits. The figure shows annual earnings for a worker who earns $20,000 per year for the first twenty years of employment and $40,000 per year for the next 20 years. All employers have a defined benefit pension plan with a benefit formula of 1.0 percent per year of service × salary average over the past 5 years.

Total earnings are the same whether the worker remains with the same employer for the full period or changes jobs. The worker who stays with the same employer will have an annual pension benefit of $16,000 (0.01 × 40 years × $40,000). The worker who changes jobs after 20 years will receive two pensions totaling $12,000 annually—$4,000 from job 1 (0.01 × 20 years × $20,000) plus $8,000 from job 2 (0.01 × 20 years × $40,000). Thus changing jobs once lowers the annual retirement benefit by $4,000.

Workers retiring at or after the early retirement age but before the normal retirement age receive a reduced benefit. The reduction in the annual benefit is applied because an individual who starts receiving benefits at an earlier age can be expected to receive benefits for a longer period of time than one who retires later. If benefits were actuarially reduced, the present value of the lifetime pension benefits would be the same regardless of the age at which the person retired.

Most pensions in the twenty-first century provide early retirement benefits that are reduced by a factor less than the "actuarial rate." This means that early retirement is subsidized relative to retirement at the normal retirement age. In other words, the benefit is reduced by less than the amount that is consistent with life expectancy. As a result, these plans provide a strong incentive for workers to retire prior to the normal retirement age. Recent studies examined individual plans with characteristics that resulted in a substantial loss of pension wealth for those who continued to work after the age of early retirement. In some plans, employees lost up to half of the present value of their lifetime pension wealth by working past early retirement up to age 65 (Burkhauser 1979; Fields and Mitchell 1984).

The impact of continued employment on the present value of pension benefits could also be illustrated with a simple numerical example. Consider a pension plan with a normal retirement age of 65 and a benefit formula that specifies that a maximum of 30 years of service can be used to calculate benefits. Benefits are determined as one percent per year of service times the average of the last three years of earnings. A worker reaches age 65 having worked for the company for 30 years. She has been earning $25,000 per year for the past five years and expects to continue to earn $25,000 per year if she remains with the firm. This worker expects to die at age 80.

If she retires at age 65, the worker would receive $7,500 per year for each of the next 15 years before she dies at age 80; however, if she works one more year and then retires at age 66, she would receive the same $7,500 per year for the next 14 years. Thus, by continuing to work, the employee gives up $7,500 per year. In a real sense, her total compensation for working at age 65 is not $25,000 but $17,500 (i.e., $25,000 in earnings minus the $7,500 in pension income forgone). While this example (depicted in Figure 2.3) ignores the potential for future benefits to rise with additional years of service and higher average earnings, it does illustrate the potential for a substantial loss in pension wealth with continued employment. The magnitude of this pension loss depends on various pension characteristics. Firms seeking to provide retirement incentives can adopt plan characteristics that increase the size of the loss in pension wealth with continued employment and can determine the age at which the loss begins.

The decline in pension wealth follows from a dramatic decline in the annual benefit accrual. Benefit accruals prior to reaching the age of early retirement can represent a large component of total compensation. After qualifying for early retirement benefits, benefit accruals drop sharply and can become negative (Kotlikoff and Wise 1987, 1989). This drop in total compensation and immediate access to retirement benefits provide strong incentives for employees to retire. Numerous empirical studies have shown that age-specific retirement rates are much higher at these

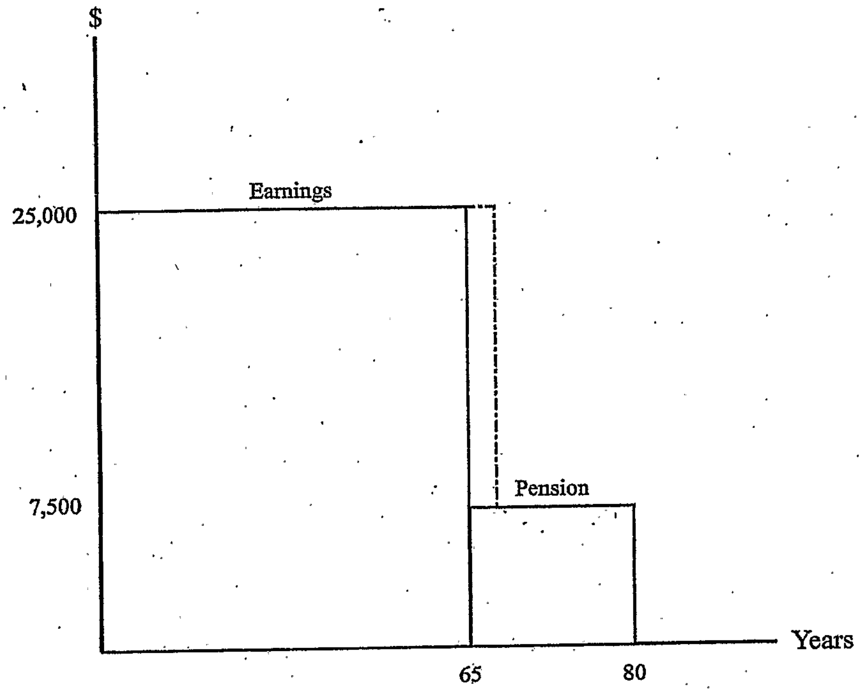


Figure 2.3. Impact of continued employment on pension wealth. A worker is employed at a company with a defined benefit pension plan using a benefit formula of 1.0 percent per year of service × salary average over the past 3 years. The plan specifies that a maximum of 30 years can be used in determining retirement benefits, the normal retirement age is 65, and the pension doesn't have an early retirement age. Assume that the worker at age 65 has 30 years of service, has been earning $25,000 per year for the past 5 years, and expects to earn $25,000 per year until retirement. The worker expects to die at age 80 regardless of the age of retirement. If retirement occurs at age 65, the worker will receive a pension of $7,500 per year for 15 years (0.01 × 30 years × $25,000). If retirement is delayed for 1 year, the worker will receive the same $7,500, but only for the 14 years of remaining life.

Prior to reaching the normal retirement age, the worker receives $25,000 in case; moreover, future pension benefits are increasing because of the additional years of service. After the worker passes the normal retirement age, total compensation is now $25,000 in case minus the $7,500 in pension benefits forgone. Thus passing the normal retirement age results in a substantial decline in total compensation and presents a strong economic incentive for the worker to retire.

times (Lumsdaine, Stock, and Wise 1994; Kotlikoff and Wise 1989; Quinn, Burkhauser, and Myers 1990). Firms can determine the age at which these incentives become effective, and the size of the incentive, by setting the age of early and normal retirement, the magnitude of the reduction factor, and other pension characteristics. Thus, pensions can be an important human resource management tool for employers seeking to influence the age of retirement of their workforce.

Prior to the middle of the twentieth century, relatively few firms included early retirement provisions in their pension plans (Schieber 2002). Instead, these plans merely specified a normal retirement age and required workers to meet certain age and service qualifications. In these early defined benefit plans, the retirement incentives described above would occur, or "kick in," at the normal retirement age. In addition, many public employers adopted mandatory retirement policies as part of their early pension plans. The mandatory retirement age was typically age 65, the same age as the normal retirement in their pension plan. Both the army and navy of the United States adopted mandatory retirement during the Civil War period in an effort to purge the officer corps of elderly, senior officers.[3] Of course, these veterans with many years of military service were provided a pension. Thus, the federal government achieved the desired retirement patterns while providing a continuing source of income for its retirees.

Taken together, the development of modern pension economics has demonstrated the financial incentives associated with defined benefit pension plans. Economic theory has been used to indicate the value of future pension benefits and to show how these benefits change with continued employment. Empirical studies indicate that pension-covered workers have lower quit and layoff rates compared to similar workers whose employers do not provide a pension plan. Furthermore, this review of the contemporary literature on pensions suggests that they are optimal or efficient contracts between employers and workers. An optimal or efficient contract is one in which both parties are made better off from the adoption of a pension contract (Craig 1995). Obviously, government policymakers in the nineteenth century were not aware of these economic studies; however, their actions indicate that they understood many of these incentives. The early use of pensions in military organizations is consistent with modern theories of pension economics. Consider, for example that the military is particularly susceptible to the costs of turnover. The jobs are often highly specialized with few private-sector parallels, and a regiment in the field or ship at sea cannot easily replace many of its key personnel. The need to retain these individuals during times of conflict was extremely important to the nation. In addition, it was often necessary to recall discharged veterans to active duty when war broke out. Retirement pensions provided a form of compensation that men simply could not find in civilian employment in the nineteenth century. In addition, the U.S. military was a leader in providing disability benefits to its personnel. A man who was about to storm an enemy trench or board an enemy man-of-war could take some comfort in knowing he or his widow would be taken care of should he be wounded or killed in action.

Defined Contribution Plans

Defined contribution plans do not specify an annual benefit at the normal retirement age. Instead, these plans are based on annual contributions to pension accounts, and retirement benefits are determined by the size of the account when the individual converts the account balance into an annuity. Contribution rates tend to be the same percentage of earnings throughout one's career. In general, these plans are more "age neutral" in their effect on worker behavior.

Coverage by a defined contribution plan clearly is an employee benefit with value for workers. These plans can help organizations attract and retain workers. However, defined contribution plans typically do not impose a loss in pension benefits on vested workers who leave the firm prior to early or normal retirement. As a result, organizations with this type of plan will have higher turnover rates compared to those with defined benefit plans. In addition, there are no magic retirement dates in defined contribution plans; so age-specific retirement rates are likely to increase more smoothly in firms with these types of plans.

Until the last quarter of the twentieth century, employers primarily relied on defined benefit pension plans; this is true of almost all the public plans examined in this volume. Over the last three decades, employers, both public and private, have increasingly turned to defined contribution plans. Reasons for this change include new government regulations that have increased the administrative cost of defined benefit plans relative to defined contribution plans (Clark and McDermed 1990), the introduction of new types of defined contribution plans such as 401(k) plans (Papke 1999), and changes in the structure of the U.S. economy. Workers, and perhaps employers too, in the twenty-first century seem to prefer pension plans with individual accounts that are more portable than the benefits in defined benefit plans.[4]

Because defined contribution plans create a fund into which the contributions are placed, they also require assets that can be purchased and placed in the fund. Limited access to immature financial markets is another reason that most nineteenth-century pension plans were defined benefit plans. It would not have been easy for the typical American in the 1800s to invest retirement funds in a timely manner in relatively secure accounts. Mutual funds did not exist, and the occupation of financial planner was unknown. There were fledgling securities markets in major port cities, but for an individual living inland from the East Coast or in rural areas, buying and selling securities would have been very difficult. Although financial markets developed quickly in the post-revolutionary period, access to these markets remained quite limited for most of the population.

At the time of the Treaty of Paris in 1783, which ended the Revolutionary War, there were essentially no organized stock or bond markets in America. Shortly thereafter, organized financial markets did begin to develop in Philadelphia, New York, Boston, Baltimore, and Charleston. At the end of the war, there were various colonial debt instruments outstanding, such as Loan Office Certificates and Indents. The buying and selling of these instruments was ubiquitous. Alexander Hamilton consolidated the war debt during his term as the first secretary of treasury. This action created about $60 million of marketable long-term bonds, which were held by the newly created state governments as well as approximately 14,000 individual investors. In other words, only about 0.25 percent of the population owned U.S. government securities. In 1791, the First Bank of the United States was chartered and its stock became actively traded, at least in the major cities. The U.S. bonds and stock of the First Bank were quite actively traded in all of the major markets as well as between markets. In addition, a large portion of U.S. assets was held in London and Amsterdam.

In addition to U.S. bonds and stocks, states eventually began to charter banks, and these new financial institutions sold stock to the public. There were also various canal, toll-bridge, and turnpike companies with outstanding shares of stock that could be purchased by interested investors. The New York Stock & Exchange was formed in 1817 to facilitate the trading of shares of stock. During this period, financial markets were typically limited to the shares of firms in the local area. Integration of these emerging markets took several decades accompanied by improvements in the transportation network and communication, thus reducing the time required for news to move from one market to another.

In 1790, the travel time between New York and Boston was about four days; it required one day to get from Philadelphia to New York and three days from Philadelphia to Baltimore. By 1810, travel time from New York to Boston had been reduced to three days and from New York to Philadelphia to less than 24 hours. Similarly, the time required for information to pass between the major cities continued to decline throughout the nineteenth century. By 1830, a traveler could go between New York and Boston in less than a day and travel time between Philadelphia and New York or Baltimore was less than twelve hours (Pred 1973). Of course, communication with European financial centers still required many days. Travel between Philadelphia and Europe in 1800 took just over two months. Between 1818 and 1832, required travel time fell to about 38 days. The advent of steamships in the middle of the century reduced sailing time to 13 to 22 days (Pred 1973; Officer 1996). Thus the primitive nature of financial markets and financial market information tended to work against the use of defined contribution pension plans.

The primary or benchmark security in the early republic was federal debt; however, throughout much of this period, the federal government was redeeming its debt, thus further limiting investment options in this already thin financial market. Gradually over the nineteenth century, financial markets expanded with the growth of the American economy while communications and transportation improvements made it possible for economic news to spread more quickly from one market to the other. Financial markets at the end of the century were certainly more mature, integrated, and broader based than those in 1800. Financial innovations continued into the twentieth century, making it easier for workers and firms to adopt and manage defined contribution plans.

Early Public Sector Pension Plans

Pension economics and the use of economic theory to explain the human resource policies of firms are relatively recent innovations. The ensuing chapters illustrate that nineteenth-century policy-makers understood many of the incentives associated with pension plans. Federal government officials developed plans and adopted specific characteristics that helped the military attract, retain, and motivate army and navy personnel and then to retire them in an orderly manner at desired ages. Similarly, leaders of large cities and then state governments began to offer retirement plans to important government workers such as personnel in fire and police departments and school teachers. Pension plans became important components of labor compensation in the public sector and the development of these plans illustrates that employers were aware of the economic incentives associated with pension plans.

As noted above, historically, public employers primarily selected defined benefit plans for their workers. Among these early defined benefit plans were the federal military plans and most of the early state and local pensions. This choice of defined benefit plans may have occurred because the early plan creators and managers recognized the greater quit, performance, and retirement incentives in defined benefit plans compared to defined contribution plans. Another possible explanation for the early use of defined benefit plans is that the typical worker had few if any financial assets and did not want to bear the investment risk associated with defined contribution plans. Furthermore, as noted, the financial markets of the United States in the nineteenth century were rather thin, were concentrated in the larger cities, and were notorious for their maltreatment of small investors. Thus, workers would have had relatively few investment options for their funds in their individual defined contribution accounts. As a result, defined benefit plans would seem to have been the optimal pension plan for nineteenth-century American workers. The review now turns to the history of these plans.

Notes

1. McGill et al. (1996) provide a detailed description of these two different types of plans, how they are funded, the rate of benefit accruals, and so forth.

2. Since 1974, the federal government has required minimum vesting standards for tax-qualified pension plans—that is, plans that qualify for the tax exemptions conveyed by federal tax law. Currently, qualified plans must provide for 100 percent vesting after five years of service or use a graded vesting formula that results in full vesting after seven years.

3. Mandatory retirement policies were widely used by large private firms until the last decade of the twentieth century. Mandatory retirement provisions also generally covered public sector jobs. Amendments to the Age Discrimination in Employment Act in 1986 effectively ended the use of mandatory retirement in most jobs.

4. Recently, many large employers have amended their defined benefit plans to include individual accounts and the potential for lump sum distributions (Clark and Schieber 2002 a, b). These hybrid plans have many of the characteristics of defined contribution plans; however, for administrative and funding purposes they are defined benefit plans.

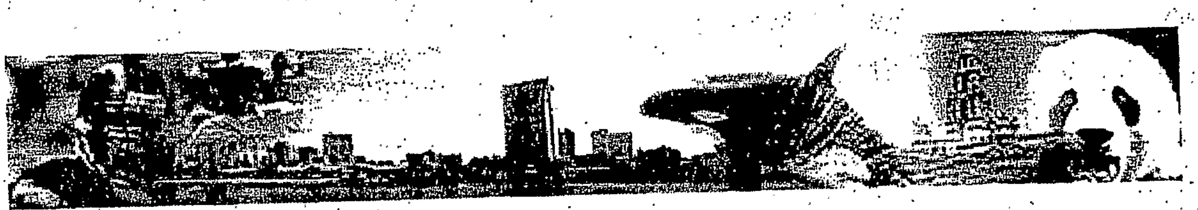
EXHIBIT 2

SAN DIEGO CITY

EMPLOYEES' RETIREMENT SYSTEM

ANNUAL ACTUARIAL VALUATION

June 30, 2004



Submitted to

THE RETIREMENT BOARD

San Diego City Employees' Retirement System

San Diego, California

San Diego City Employees' Retirement System
Unfunded Actuarial Accrued Liability
June 30, 2004

(City Only)

Derivation of Experience Gain (Loss)

The actuarial gains or losses realized in the operation of the Retirement Association provide an experience test. Gains and losses are expected to cancel each other over a period of years (in the absence of double-digit inflation) and sizable year-to-year fluctuations are common. Detail on the derivation of the actuarial gain(loss) is shown below.

1)	UAAL* at beginning of year	$1,157,194,039
2)	Beginning of year accrued liability payment	(19,460,838)
3)	Interest accrual ((1) + (2)) x .08	91,018,656
4)	Increase due to assumption changes	35,091,437
5)	Explicit recognition of COLA annuity for active members	46,681,164
6)	Expected UAAL at end of year (1) + (2) + (3) + (4) + (5)	1,310,524,458
7)	Actual UAAL at end of year	1,368,648,032
8)	Gain(loss): (6) - (7)	(58,123,574)
9)	Gain(loss) as percentage of actuarial accrued Liabilities at beginning of year $3,532,625,521	(1.6)%

* Unfunded Actuarial Accrued Liability

Unfunded Actuarial Accrued Liability

Total actuarial liabilities	$3,997,328,084
Assets allocated to funding	$2,628,680,052
Unfunded Actuarial Accrued Liability	$1,368,648,032

EXHIBIT 3

SAN DIEGO CITY

EMPLOYEES' RETIREMENT SYSTEM

ANNUAL ACTUARIAL VALUATION

June 30, 2004

Submitted to

THE RETIREMENT BOARD

San Diego City Employees' Retirement System

San Diego, California

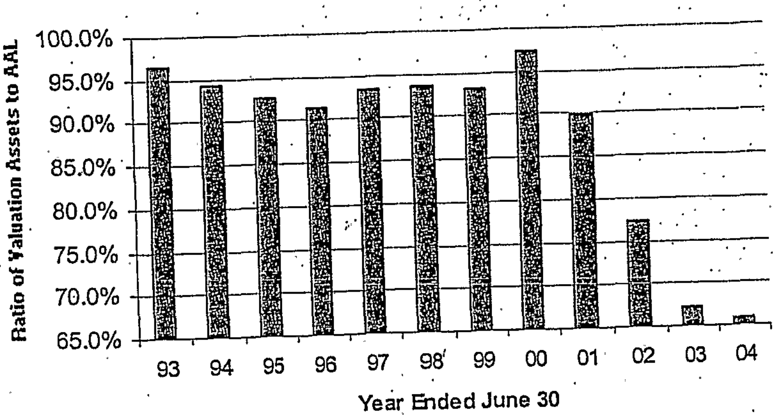
San Diego City Employees' Retirement System
Funding Process Indicators - Historic Comparison

($ in Thousands)

Valuation Date	Valuation Assets	AAL	Funded Ratio	UAAL	Member Payroll	Ratio to Payroll
		Continuation Indicators				
6/30/93	$1,137,019	$1,178,311	96.5%	$41,292	$320,624	12.9%
6/30/94[1]	$1,216,063	$1,290,927	94.2%	$74,864	$338,440	22.1%
6/30/95	$1,316,903	$1,421,150	92.7%	$104,247	$350,584	29.7%
6/30/96[2]	$1,480,772	$1,620,373	91.4%	$139,602	$365,089	38.2%
6/30/97	$1,632,361	$1,748,868	93.3%	$116,507	$382,715	30.4%
6/30/98[1]	$1,852,151	$1,979,668	93.6%	$127,517	$399,035	32.0%
6/30/99	$2,033,153	$2,181,547	93.2%	$148,394	$424,516	35.0%
6/30/00	$2,459,815	$2,343,400	105.0%	($116,414)	$448,502	(26.0)%
6/30/00[3]	$2,459,815	$2,528,774	97.3%	$68,959	$448,502	15.4%
6/30/01	$2,525,645	$2,809,538	89.9%	$283,893	$481,864	58.9%
6/30/02	$2,448,208	$3,168,921	77.3%	$720,713	$535,157	134.7%
6/30/03	$2,375,431	$3,484,832	68.2%	$1,109,401	$533,595	207.9%
6/30/03[4]	$2,375,431	$3,532,626	67.2%	$1,157,194	$533,595	216.9%
6/30/04	$2,628,680	$3,962,237	66.3%	$1,333,557	$540,181	246.9%
6/30/04[5]	$2,628,680	$3,997,328	65.8%	$1,368,648	$540,181	253.4%

AAL - Actuarial Accrued Liability
UAAL - Unfunded Actuarial Accrued Liability

Historic Comparison of Funded Ratio



[1] Reflects revised actuarial and economic assumptions
[2] Reflects Manager's Proposal
[3] Reflects Corbett non-contingent benefit increases
[4] Includes change in benefits for General Members
[5] Reflects revised actuarial assumptions

EXHIBIT 4

GRS

ABRIEL, ROEDER, SMITH & COMPANY
Consultants & Actuaries

9171 Towne Centre Drive • Suite 440 • San Diego, California 92122 • 858-535-1300 • FAX 858-535-1415

April 20, 2004

Members of the Pension Reform Commission
c/o SDCERS
401 B Street, Fourth Floor
San Diego, CA 92101

RE: Completion of Item #1

Dear Members of the Commission,

We have established the cumulative financial impact of the three benefit increases relating to Manager's Proposal 1 (MP 1), Manager's Proposal 2 (MP 2) and the "Corbett" settlement as of June 30, 2003. This does not incorporate the impact of other contingent benefits (Item #10 of your RFP request).

The cumulative value of the benefit increases, including considering the time value of money, for MP1, MP2 and the **non**-contingent Corbett benefit increases as of June 30, 2003 is $467.3 million

The contingent portion of the Corbett retiree increases was not paid out as of June 30, 2003. We calculated an estimated value of $75.5 million as of the June 30, 2000 valuation date. The affected retirees are a closed group. It is still not entirely clear to us how benefits, if any are applicable, would apply to the estates of retirees who have died in the intervening time, once the conditions for payment have been triggered.

Sincerely,

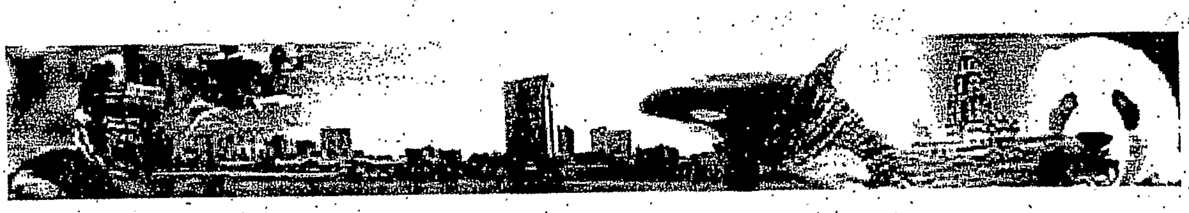
Rick Roeder

Rick Roeder, EA, FSA, MAAA

CC: Larry Grissom
Paul Barnett
Lamont Ewell

EXHIBIT 5

SAN DIEGO CITY
EMPLOYEES' RETIREMENT SYSTEM
ANNUAL ACTUARIAL VALUATION
June 30, 2004



Submitted to
THE RETIREMENT BOARD
San Diego City Employees' Retirement System
San Diego, California

San Diego City Employees' Retirement System

Summary of Retired Members and Beneficiaries Included

to be used in the June 30, 2004 Actuarial Valuation

(City Only)

The following include DROP Retirements

			Averages				New Retirees[2]		
	No.	Annual Allowance	Annual Allowance	Attained Age	Age at[1] Retirement	Service at Retirement	No.	Age	Allowance
General Members									
6/30/2004	3,399	$72,634,781	$21,369	69.9	57.8	23.1	226	58.1	$36,719
6/30/2003	3,223	63,212,711	19,613	70.2	57.9	22.8	332	58.6	43,399
Percent Increase	5.5%	14.9%	9.0%						
Safety Members									
6/30/2004	2,324	88,659,837	38,150	63.2	49.2	22.7	87	52.2	64,018
6/30/2003	2,244	81,703,877	36,410	62.9	49.1	22.5	138	52.8	62,011
Percent Increase	3.6%	8.5%	4.8%						
6/30/04 Grand Total	5,723	$161,294,618	$28,184	67.2	54.2	22.9	313	56.5	$44,307
6/30/03 Grand Total	5,467	144,916,588	26,508	67.2	54.2	22.7	470	56.9	$48,864
Percent Increase	4.7%	11.3%	6.3%						

As of June 30, 2004

640 General retirees have purchased 2,942 years of "permissive" service before retirement.

207 Safety retirees have purchased 492 years of "permissive" service before retirement.

[1] Retirees and disabilities only; beneficiaries excluded

[2] DROP members who retire are not included as new retirees.

EXHIBIT 6

FINAL REPORT

CITY OF SAN DIEGO PENSION REFORM COMMITTEE

SEPTEMBER 15, 2004

Investment performance	6%
Under-funding by City	10%
Use of Plan earnings for contingent benefits	12%
Net Actuarial losses	31%
Benefit improvements	41%
	100%

Note: This analysis of under-funding does not include future impact of contingent Corbett Settlement and 13th Check.

It should be noted that the Retirement Board commissioned a similar study that resulted in a significantly different allocation resulting from the interdependence of the various factors. The variance is currently being analyzed by the Retirement Board. The most insignificant variance, however, was in investment performance where the Retirement Board's study indicates an allocation factor of 7% rather than 6%.

Description of Causes

Investment performance

While this is the least significant factor mathematically, it warrants discussion because the market "bubble" of the late 1990s masked the other factors, providing an unwarranted sense of well-being by the Retirement Board and the City.

As discussed in the initial section, the City's annual contribution is calculated using a variety of actuarial assumptions. One of those assumptions is an 8% average rate of return on investment. Looking back over ten years, the experience has, in fact, been 8% on average over the long-term.

During the late 1990s, the City felt comfortable not only increasing benefits but also making lower contributions than it should have. When the market adjusted back to the investment rate of return originally anticipated in the actuarial assumptions, the fiscal impact of decisions made during the bubble became evident. As a result, there was an inclination to blame the declining funded status of the Plan on the decreasing market rather than acknowledging that the stabilization of the market was simply baring the results of ill-advised decisions.

Under-funding by the City

As previously discussed, the term "full actuarial funding" is misleading given the City's method

EXHIBIT 7

GABRIEL, ROEDER, SMITH & COMPANY
Consultants & Actuaries
9171 Towne Centre Drive • Suite 440 • San Diego, California 92122 • 858-535-1300 • FAX 858-535-1415

May 4, 2004

To: Pension Reform Commission

RE: Requested Tasks by the Pension Reform Commission

Dear Members of the Commission,

We are summarizing further results of our actuarial analysis. Item numbers referenced are consistent with our fee proposal letter. There are a couple additional deliverables which we will finish checking this week.

For ease of comparison, all changes, due to alternate scenarios are in percents of pay and use actuarial assumptions specified in Manager's Proposal 2. City contributions are assumed to be paid at the **beginning** of the fiscal year.

We typically use percents of pay in expressing changes. This is due to the City's history of payroll growth, assumed future payroll growth and the manner in which unfunded liabilities are amortized (18 years remaining as of June 30, 2003, financed as a level percent of payroll).

If it is desired to translate such percents, where indicated, into current dollars, then one of two numbers is useful:

June 30, 2003 Valuation Payroll	$533,595,407
Projected June 30, 2004 Valuation Payroll	$556,273,212

The projection is based on the 2003 valuation payroll and SDCERS' 4.25% inflation assumption.

2. Impact of Pick Ups

You have asked us to evaluate the cumulative amount of City pick ups of employee contributions since 1996 and any related actuarial impact if pick ups did not exist and the like amount of City contributions were instead applied to the unfunded actuarial accrued liability.

We have calculated the amounts of the pick ups for the fiscal year ends 1997-2003 to be $160,074,161. The cumulative value, inclusive of the time value of money, of such pick ups is $207,911,404 as of June 30, 2003. Because of the fixed rates in the Manager's Proposal 1 (as long as the City's funded ratio exceeded 82.3%), there would not have been year-to-year impact on the City's actual contribution due to the pick up. However, there would be significant impact on the June 30, 2003 actuarial rate, as follows if the amounts picked up were instead paid by the employees and the "freed up" pick ups were put into SDCERS.

	Current	No Pick Up	Decrease
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	13.12%	2.87%
TOTAL	27.94%	25.07%	2.87%
Unfunded Liability (millions)	$1,157	949	208
Funded Ratio	67.2%	73.1%	(5.9)%

The total amount of the negotiated pick up is not contributed by the City. Instead, a smaller amount is contributed to reflect anticipated savings from having to pay lesser refunds. Pick ups are not refundable to employees.

The establishment of the pick up program preceded the implementation of Manager's Proposal 1.

3. Alternate Actuarial Investment Assumptions

Calculate the 2003 actuarial rate by changing the following economic assumptions to:

Inflation	4.0%	(currently 4.25%)
Real Return	3.5%	(currently 3.75%)
Total Assumed Return	7.5%	(currently 8%)

	Current	New Assumptions	Increase
Normal Cost	11.95%	13.87%	1.92%
Amortization	15.99%	18.78%	2.79%
TOTAL	27.94%	32.65%	4.71%
Unfunded Liability (millions)	$1,157	1,382	225
Funded Ratio	67.2%	63.2%	(4.0)%

4. Calculate the actuarial rate without COLA

If all future 2% annual COLA increases were eliminated, the impact on the actuarial rate would be as follows:

	Current	No COLA	Decrease
Normal Cost	11.95%	7.83%	4.12%
Amortization	15.99%	7.56%	8.43%
TOTAL	27.94%	15.39%	12.55%
Unfunded Liability (millions)	$1,157	547	610
Funded Ratio	67.2%	81.3%	(14.1)%

Suppose the elimination of the 2% COLA were restricted to future retirees:

	Current	No COLA	Decrease
Normal Cost	11.95%	7.83%	4.12%
Amortization	15.99%	11.48%	4.51%
TOTAL	27.94%	19.31%	8.63%
Unfunded Liability (millions)	$1,157	830	327
Funded Ratio	67.2%	74.1%	(6.9)%

We have assumed **no** change in the employee contribution rate. It is likely that the issue of employee contribution rates being decreased would arise. This issue could become further complicated due to the significant pick ups currently in place.

There are legal issues involving "contract" impairment if this course is pursued for current members.

6. Amortization Period Alternatives

Recalculate the 2003 rate with a 30-year amortization period.

	Current	30-Year	Decrease
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	11.52%	4.47%
TOTAL	27.94%	23.47%	4.47%

Recalculate the 2003 rate with a 10-year amortization period.

	Current	10-Year	Increase
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	25.29%	9.30%
TOTAL	27.94%	37.24%	9.30%

Recalculate the 2003 rate with a 10-year/30-year amortization blend.

We have calculated a blended amortization rate which uses 10-year amortization of the $467.3 million identified as a benefit increase coincident with or following Manager's Proposal #1. It is sensible to amortize this amount over a shorter period of time since the average future working lifetime of the active employees, to whom the unfunded liability relates, is between ten and fifteen years.

The balance of the unfunded liability as of June 30, 2003, $689.9 million, is amortized over 30 years.

	Current	10/30 Blend	Increase
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	17.08%	1.09%
TOTAL	27.94%	29.03%	1.09%

7. Evaluation of Asset Smoothing Methods

Use existing asset smoothing methodology but shorten smoothing period to 1, 2 and 3 years as of June 30, 2003:

Shorten Ratio of Market to Book to One Year

Existing SDCERS Valuation Assets Attributed to City	$2,375,431,482
Valuation Assets With Revised Smoothing	$2,331,298,987
Net Decrease in Valuation Assets	$ 44,132,495
Revised Actuarial Rate	28.55%
Revised Funded Ratio	66.0%

Shorten Ratio of Market to Book to Two Years

Existing SDCERS Valuation Assets Attributed to City	$2,375,431,482
Valuation Assets With Revised Smoothing	$2,258,701,035
Net Decrease in Valuation Assets	$ 116,730,447
Revised Actuarial Rate	29.55%
Revised Funded Ratio	63.9%

Shorten Ratio of Market to Book to Three Years

Existing SDCERS Valuation Assets Attributed to City	$2,375,431,482
Valuation Assets With Revised Smoothing	$2,270,175,483
Net Decrease in Valuation Assets	$ 105,255,999
Revised Actuarial Rate	29.39%
Revised Funded Ratio	64.3%

8. Reduction to Normal Cost for Future Hires by Extending Final Average Compensation Period from 1 to 3 Years

Safety	-1.38%
General	- 0.90%
Total	-1.06%

This assumes **no** change in employee contributions.

9. Impact of 13th Check on Funded Position of Plan

You have asked us to evaluate the cumulative impact of the 13th Check. Our analysis evaluates the impact **since** 1996.

We have calculated the amounts of the 13th checks for the fiscal year ends 1997-2003 to be $23,111,139. The cumulative value, inclusive of the time value of money, of such pick ups is $30,315,418 as of June 30, 2003. Because of the fixed rates in the Manager's Proposal 1 (as long as the City's funded ratio exceeded 82.3%), there would not have been year-to-year impact on the City's actual contribution due to the pick up since 1996. However, there would be significant impact on the June 30, 2003 actuarial rate, as follows if the amounts paid were instead retained in the SDCERS trust.

	Current	No 13th Check	Decrease
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	15.57%	0.42%
TOTAL	27.94%	27.52%	0.42%
Unfunded Liability (millions)	$1,157	1,127	30
Funded Ratio	67.2%	68.1%	(0.9)%

We can identify the amounts of the 13th checks for as many years as SDCERS has retained records. We are still in the process of identifying such amounts for each year since program inception.

10. Impact of Other Contingent Benefits on Funded Status of Plan

You have asked us to evaluate the cumulative impact of contingent benefits other than 13th Check. Our analysis evaluates the impact since 1996.

We have calculated the amounts of other contingent benefits for the fiscal year ends 1997-2003 to be $91,908,589. The cumulative value, inclusive of the time value of money, of such benefits is $111,141,394 as of June 30, 2003. Because of the fixed rates in the Manager's Proposal 1 (as long as the City's funded ratio exceeded 82.3%), there would not have been year-to-year impact on the City's actual contribution due to the pick up since 1996. However, there would be significant impact on the June 30, 2003 actuarial rate, as follows if the amounts paid were instead retained in the SDCERS trust.

	Current	Other Benefits	Decrease
Normal Cost	11.95%	11.95%	0.00%
Amortization	15.99%	14.45%	1.54%
TOTAL	27.94%	26.40%	1.54%
Unfunded Liability (millions)	$1,157	1,046	111
Funded Ratio	67.2%	70.4%	(3.2)%

12. Impact of Service Purchase Subsidy on SDCERS

Just prior to higher service purchase rates going into effect in November, there was a deluge of requests from members (roughly 3,000) for cost information. Not all requests will result in purchase. It would not be unreasonable to guess that half of the current requests will result in purchase.

As of June 30, 2003, there were 2,339 members who purchased service since program inception.

The one year for which we have excellent information as to both liabilities and related contract purchase amounts is the year ending June 30, 2003.

Total Purchasers:	812
Average Age	49.1 years
Average Service Purchased	4.2 years
New City Liability	$46,000,959
Member Contract Value	$33,300,955
Actuarial Loss	$12,700,004

This means the average actuarial loss per year of service purchased was roughly $3,725.

If there are 1,500 members who have purchased service since June 30, 2003 or are in the pipeline, our guesstimate is that the added actuarial loss will be in the $22-$25 million range. The impact of this will not entirely be reflected in the June 30, 2004 valuation since staff indicates that request processing will continue for the balance of the calendar year.

We look forward to answering your questions.

Sincerely,

Rick Roeder

Rick Roeder, EA, FSA, MAAA

EXHIBIT 8

REPORT ON INVESTIGATION

The City of San Diego, California's

Disclosures of Obligation to Fund the

San Diego City Employee's Retirement System

and Related Disclosure Practices

1996-2004

with

Recommended Procedures and Changes to the Municipal Code

September 16, 2004

Paul S. Maco
Richard C. Sauer
Vinson & Elkins L.L.P.
Washington, D.C.

The City of San Diego has developed an expensive retirement system for its municipal workers that it has failed to fully fund under the actuarial principal that pension liabilities generated today should be funded today, not passed off onto future generations of taxpayers. This situation evolved in piecemeal fashion through trade-offs between City management and its municipal unions, in each instance reflecting the short-term time horizon of the City's budgetary process. The most significant measures required the acquiescence of the SDCERS Board. SDCERS is formally independent of the City but a majority of its trustees are either City administrators or union officials.

As a result of its historically strong anti-tax attitudes, San Diego is a low-revenue city. Like other local governments in California, San Diego's budget is affected from time to time by reductions in funds received from the State. The costs of providing public safety and maintaining quality of life increase with the costs of providing its workforce with a compensation package competitive with that of other communities. San Diego is also a city with strong municipal unions. These factors have repeatedly combined to place the City's budget under significant strain. When City management cannot escape making concessions to the municipal unions but finds the larder of its operating funds bare, the easy solution has been to grant additional retirement benefits, rather than salary increases, thus avoiding the need for layoffs and cuts in services. On two occasions, moreover, the City made the provision of substantial benefit improvements contingent upon the agreement of the SDCERS Board that the City's contributions to the System would be at negotiated rates lower than the actuarially calculated rates. From July 1, 1997, through July 1, 2004, the City under-funded SDCERS pursuant to those agreements. Thus at the same time the City was agreeing to additional benefits for retirees, it was arranging to reduce its contributions to the System. This allowed the City, in effect, to finance the cost of the concessions over a multi-year period. Moreover, the City took advantage of certain vagaries of "actuarial science" and pension accounting to further minimize its contributions to SDCERS.

Many of the measures used to shift City liabilities to SDCERS into the future applied the dangerous and widely misused concept of "surplus earnings."[9] Surplus earnings are defined under the Municipal Code as the realized returns on SDCERS assets above the rate projected by its actuary as necessary to pay its future liabilities when due. The view that whenever cash returns exceed the long-term actuarial benchmark the result is "free money" violates another actuarial principal. Returns on assets are projected as averages over decades. It is assumed that returns will fluctuate over time, with strong returns in some years offsetting weak returns in others. When, instead, above-average returns are defined as "surplus" and siphoned off for other uses, the result may be the depletion of the system's financial strength.

9 As described below, many other governmental entities have used surplus earnings from their retirement systems to fund a variety of benefits. San Diego, however, appears to be among the more aggressive and creative in this regard.

EXHIBIT 9

REPORT ON INVESTIGATION

The City of San Diego, California's

Disclosures of Obligation to Fund the

San Diego City Employees' Retirement System

and Related Disclosure Practices

1996-2004

with

Recommended Procedures and Changes to the Municipal Code

September 16, 2004

Paul S. Maco

Richard C. Sauer

Vinson & Elkins L.L.P.

Washington, D.C.

IV. SDCERS changes its actuarial methodology

The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations. Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them.

In 1991, for example, the SDCERS Board approved a change in the method of calculating the System's annual cost. The annual cost consists of two components: (1) the actuarial present value of the pension benefits and expenses allocated to a particular year and (2) the amount necessary to amortize the portion of the actuarial accrued liability ("AAL") that exceeds System assets (i.e., "UAAL"). The annual cost, in turn, is used to determine the City's actuarially required contributions. Until this time, SDCERS had utilized the EAN method for determining the System's annual cost. The EAN method allocates the total value of a member's expected benefit liability as a level percent of payroll from entry age until retirement. If this level percent is contributed, all actuarial assumptions are met and there are no design changes, this level percent of pay contribution is designed to be sufficient to fund a member's retirement benefit and there is no UAAL. This level cost per person, when aggregated with the level cost for all members, will remain relatively constant for a fund if the average age at hire of the population remains relatively stable, design and actuarial assumptions are unchanged, and experience matches actuarial assumptions. Among the six actuarial funding methods approved by the Governmental Accounting Standards Board ("GASB"), it recommends itself as a relatively stable and conservative approach and, for this reason, is commonly used by governmental entities. Indeed, in a recent survey conducted by the SDCERS staff, 21 of 23 systems surveyed employ the EAN method.

SDCERS, however, chose to migrate from the EAN to the PUC method. The PUC method evaluates the future actuarial liability of the covered group as a whole, applying various actuarial assumptions concerning population demographics and returns on system assets. For an individual member, the PUC method allocates a cost as a percent of payroll that increases geometrically from entry age until ultimate retirement. When combined for an entire population, the annual cost remains stable only if the average attained age of the membership remains stable, something few employee populations have experienced as the baby boomers have been aging. A notable characteristic of the PUC method is that, at least in the early years after its adoption, it tends to generate a lower annual cost than the EAN method, and therefore results in lower actuarially required employer contributions. In the case of SDCERS, the change in methodology resulted in an immediate decline in AAL of approximately 2.8%.[129] Jack McGrory, San Diego's City Manager at

[129] Letter from Lawrence B. Grissom, Retirement Administrator, SDCERS, to Ann M. Smith, Tosdal, Levine, Smith & Steiner (May 16, 1996).

EXHIBIT 10

Duties and Liabilities of Public Accountants

DENZIL Y. CAUSEY, JR., D.B.A., J.D., C.P.A.

Professor of Accounting
Mississippi State University

Revised Edition

DOW JONES-IRWIN Homewood, Illinois 60430

agement misconduct by reporting it to the SEC and the public and (2) requires *effective* communication of material information so as fairly and meaningfully to inform the lay investor.

The following comments contrast AICPA and Commission views with respect to the duty of effective communication:

> Fairness in presentation is a very important concept, and perhaps it is now blending into a legal concept even while it remains an accounting one with the same name. By "fairness in presentation" I mean that the financial statements reported on by the auditor must reflect the economic realities of the entire business operation—and I emphasize the word "realities"—and must not have been arrived at merely mechanically or by rote, even though all of the procedures and processes, when taken in segments, may each have comported with generally accepted accounting principles or generally accepted auditing standards.
>
> Hence, while GAAP and auditing standards are, of course, extremely useful tools in arriving at fair presentation, they are not necessarily insurers of that arrival. This statement may represent an inherent contradiction to accountants, who believe that proper adherence to generally accepted accounting principles and auditing standards must inevitably lead to fair presentation. But I think that that distinction is understandable to nonaccountants and even to laymen who are neither accountants nor lawyers.
>
> It will not do, in my opinion, to view accounting as a modular concept which has differences from reality, so that only initiates or experts can really understand it, and they must act as interpreters for everyone else. Rather, I think that intelligent and educated persons who are not accountants, but who are businessmen and who are investors and who are lawyers and others, must be able to look at it and be informed by—and certainly not misled by—accounting statements even though they are statements that are made in a complex discipline.[55]

REASONABLE APPLICATION OF PROFESSIONAL STANDARDS

In order to produce reasonable results, GAAP and GAAS must be reasonably applied. Under GAAP and GAAS, the auditor has little authority or responsibility to see that GAAP are reasonably applied. When there are no specific criteria for selecting alternative GAAP, the auditor is discouraged from challenging any of the available alternatives. This has given rise to various schemes calculated to produce misleading results, such as artful accounting, creative accounting, and salami accounting.

Artful accounting involves incomplete disclosure, or disclosures buried in footnotes or in the auditor's report itself, or failure to give equal prominence to related matters. For example, where realization of income and the related receivables is doubtful, the auditor usually gives a "subject to realization" qualification in the report. Although disclaimers and qualifications have been effective in avoiding liability in some cases, they have not avoided liability where there has been a failure to communicate significant information that was known or should have been known to the CPA in the particular factual setting.[56]

Creative accounting involves the selective choice and/or corruption of accounting principles to present a misleading impression. Corruption is accomplished by applying accepted principles in inappropriate circumstances or in an unacceptable or misleading manner. Creative accounting sometimes goes even further and actually involves the structuring and implementing of transactions primarily for the sake of presenting an attractive financial picture with little or no regard for economic reality.[57]

Salami accounting is the practice of covering up past errors "whereby the amount of the error is sliced very thin and taken up gradually over future periods so as not to distort the main fare."[58] The incentive for salami accounting is that the auditor avoids having to blow the whistle on himself. Auditors seldom benefit from fraudulent schemes except for possibly retaining a client of dubious value; however, covering up past mistakes does provide a powerful incentive against full disclosure.

A ROLE FOR UNIFORMITY AND CONSERVATISM

If the accounting profession is to meet its challenge, uniformity and conservatism must be increasingly imposed on accounting practice. Alternative procedures give latitude in reporting that can ultimately result in investor losses.

Although both understatement and overstatement of income are undesirable, the major losses and finan-

55. Paul Gonson, "Disciplinary Proceedings and Other Remedies Available to the SEC," *Business Lawyer*, March 1975, p. 191. © 1975 by *Business Lawyer*.

56. One of the earliest court decisions involving auditor's liability warned that a "subject to realization" qualification is an unsatisfactory communication that assets are overstated. *See In re* London and General Bank, [1895] 2 Ch. 673. The case of Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976), involved a similar problem. For a summary of court decisions relating to disclaimers and qualified opinions, see note 11 in Chapter 5. For cases dealing with the unaudited situation, see note 33 in Chapter 5.

57. See Staff of Securities and Exchange Commission, Report to Special Subcomm. on Investigations of the House Committee on Interstate and Foreign Commerce on the Financial Collapse of the Penn. Central Company, 92d Cong., 2d Sess. 33–83 (1972).

58. Henry P. Hill, "Responsibilities and Liabilities of Auditors and Accountants—An Accountant's View," *Business Lawyer*, March 1975, pp. 169–80 at 179–80.

EXHIBIT 11

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ORDINANCE NO. O-15353 (O. 81-67)
(New Series)

OCT 6 1980

AN ORDINANCE AMENDING CHAPTER II, ARTICLE 4, OF THE SAN DIEGO MUNICIPAL CODE BY AMENDING SECTION 24.0907.1, RELATING TO USE OF SURPLUS UNDISTRIBUTED EARNINGS; ADDING NEW SECTION 24.0404 RELATING TO DETERMINATION OF AND QUALIFICATION FOR ANNUAL SUPPLEMENTAL BENEFITS.

WHEREAS, the City Council requested the Retirement Board of Administration (herein called "Board") to study the problem faced by retired employees as a result of extreme inflationary factors; and

WHEREAS, included within the request was the proposal that Surplus Undistributed Earnings experienced by the Retirement System (herein called "System") be treated in a manner so that 50% of said earnings be distributed to retirees under conditions and mathematical formulae to be developed by Board; and

WHEREAS, the Board established a special committee to study such distribution and submit its recommendations to the full Board; and

WHEREAS, said special committee met and deliberated on July 3 and July 15, 1980, and developed criteria for distribution to Qualified Retirees; and

WHEREAS, said criteria and distribution concept was reported to and approved by the full Board at its regularly scheduled meeting of July 18, 1980; and

WHEREAS, said distribution of Surplus Undistributed Earnings to Qualified Retirees constituted a change in pension benefits requiring an amendment to the Municipal Code of The City of San Diego and a vote of the members of the System as required by Section 143.1 of the Charter of The City of San Diego; and

WHEREAS, the Board has fulfilled its Charter responsibility and submitted to the City Council the proposed plan for distribution of Surplus Undistributed Earnings for legislative approval by the Council prior to the election of the members of the System; and

WHEREAS, the City Council, by Resolution No. 242479, dated August 12, 1980, approved the plan and submission to the system members for a vote as required by the Charter; and

WHEREAS, the election was conducted and the membership vote tallied and certified on September 15, 1980; and

WHEREAS, the members approved the proposed change in benefits set forth in the plan; and

WHEREAS, it is now necessary to amend the retirement ordinances contained in the Municipal Code in order to effectuate said changes; NOW, THEREFORE,

BE IT ORDAINED, by the Council of The City of San Diego, as follows:

Section 1. That Chapter II, Article 4, of the San Diego Municipal Code be and the same is hereby amended by amending Section 24.0907.1 to read as follows:

SEC. 24.0907.1 SURPLUS UNDISTRIBUTED EARNINGS

At the beginning of each fiscal year the Board shall determine the Surplus Undistributed Earnings of the System and shall provide for the distribution of same as follows:

Fifty percent (50%) of such amount shall be credited to the Reserve for Employer Contributions for the sole and exclusive purpose of reducing the System's liabilities; fifty percent (50%) shall be credited to an account to provide monies to pay annual supplemental benefits to Qualified Retirees. Sums transferred to the Reserve for Employer Contributions shall be credited to the accounts of the City and its contracting agencies in the same proportion as the employer reserves for their active and retired members bears to the total of all employer reserves for all active and retired members on the preceding June 30. If, at the time of the annual determination, the amount provided for the supplemental benefits is less than $100,000, no supplemental benefits will be paid in that fiscal year and the monies will be placed in a special reserve and be carried forward to ensuing years until such time as the amount to be provided for this benefit from ensuing Surplus Undistributed Earnings and the special reserve is $100,000 or more.

Surplus Undistributed Earnings shall be comprised of investment earnings received for the previous fiscal year, as defined below, less:

(1) an amount sufficient to credit interest to the contribution accounts of the members, City, and the Unified Port District at an interest rate determined by the Board and distributed in accordance with Section 24.0905 and related Board rules;

(2) an amount sufficient to meet the budgeted expenses and costs of operating the System, including all personnel and services for the fiscal year; and

(3) an amount necessary to maintain such reserves for contingencies as the Board deems appropriate on advice of its investment counselor.

Investment earnings received shall include, by way of example but not limited to, all interest received (net of interest purchased) on notes, bonds, mortgages, short-term money market instruments, and savings accounts; cash dividends received on stock investments; and all realized gains and losses from the sale, trade or conversion of any investments. It is the intent of this section that investment earnings for the purpose of distributing annual supplemental benefits to Qualified Retirees shall be determined on a cash basis, except that investment earnings shall be increased or decreased by the amount of the annual amortization of purchase discounts or premiums on interest-bearing investments earned in accordance with generally accepted accounting principles for financial reporting purposes. No subsequent changes in the method of accounting for the System shall affect the determination of investment earnings received. Surplus Undistributed Earnings shall be determined by the City Auditor and Comptroller in accordance with the definitions of this section and shall be certified by the City's independent public accountant.

Section 2. That Chapter II, Article 4, of the San Diego Municipal Code be and the same is hereby amended by adding thereto a new Section 24.0404 to read as follows:

SEC. 24.0404 ANNUAL SUPPLEMENTAL BENEFITS--QUALIFICATION AND DETERMINATION

The purpose and intent of this section is to provide necessary guidelines for effectuating the payment of annual supplemental benefits set forth in Section 24.0907.1 of this Code by (a) identifying and defining those retirees qualified to receive such benefit and (b) establishing a method for determining the amount of the annual supplemental benefit.

A. QUALIFIED RETIREES: For the purpose of identifying those retirees who shall be deemed qualified to receive the annual supplemental benefit established in this Code, the following criteria shall apply:

1. The retiree must have completed a minimum of ten (10) years continuous service as a member of the system in order to be qualified;

2. The retiree must be on the retirement payroll for the month of October of any year in which benefits are to be paid except as provided otherwise in Section 3 of this ordinance for the first year's distribution;

3. Qualified Retirees shall be limited to the following classes:

(a) Retired General and Safety members;

(b) Retired Unified Port District members; and

(c) General, Safety and Unified Port District member survivors receiving monthly pensions from the system, provided the deceased general or safety or Unified Port District member had met the minimum continuous service requirement in subsection A.1. above.

4. Legislative and Special Class safety members and the survivors of both classes shall not be eligible for participation in the annual supplemental benefit program established by this Article.

B. DETERMINATION OF BENEFIT AMOUNT AND PAYMENT THEREOF: For the purpose of determining the amount of the supplemental benefit payment to Qualified Retirees, the following process shall apply:

1. The Retirement Officer each year shall identify all Qualified Retirees on the retirement payroll for the month of October.

2. The Retirement Officer shall then determine the number of years of creditable service possessed by each Qualified Retiree identified in 1. above.

3. The number of creditable years for all Qualified Retirees shall be added together to determine the total sum of Qualified creditable years.

4. The total sum of Qualified creditable years shall then be divided into the total of Surplus Undistributed Earnings designated for distribution

pursuant to Section 24.0907.1 of this Code to arrive at a per annum dollar value for each creditable year.

5. The per annum dollar value shall then be multiplied by each Qualified Retiree's creditable service to determine the annual supplemental benefit to be paid each Qualified Retiree the following November.

6. Survivors of deceased Qualified Retirees, as defined in subsection A above, shall be eligible for annual supplemental benefits, said benefits to be determined in the same ratio as their monthly benefit bears to the monthly benefit received by their deceased retired spouse.

C. <u>MISCELLANEOUS</u>: The Retirement Board, with the cooperation and approval of the City Auditor and Comptroller, shall promulgate necessary rules to effectuate the provisions and intent of this Article.

Section 3. Irrespective of the provisions of Section 24.0907.1 relating to Surplus Undistributed Earnings, the total dollar amount of the first distribution of annual supplemental benefits to Qualified Retirees for fiscal year 1981 shall not exceed $1,000,000.00 and shall be paid in the month of December, 1980, to those Qualified Retirees or survivors on the retirement payroll for the month of November, 1980.

Section 4. This ordinance shall take effect and be in force on the thirtieth day from and after its passage.

APPROVED: JOHN W. WITT, City Attorney

By Jack Katz
Jack Katz, Chief Deputy

JK:lco:352
9/18/80
Or.Dept.:Retirement
Aud. Cert.#81222

O-15353

Passed and adopted by the Council of The City of San Diego on OCT 6 1980, by the following vote:

Councilmen	Yeas	Nays	Not Present	Ineligible
Bill Mitchell	☑	☐	☐	☐
Bill Cleator	☐	☐	☑	☐
Bill Lowery	☐	☐	☑	☐
Leon L. Williams	☑	☐	☐	☐
Fred Schnaubelt	☑	☐	☐	☐
Mike Gotch	☑	☐	☐	☐
Larry Stirling	☑	☐	☐	☐
Lucy Killea	☑	☐	☐	☐
Mayor Pete Wilson	☑	☐	☐	☐

AUTHENTICATED BY:

PETE WILSON,
Mayor of The City of San Diego, California.

CHARLES G. ABDELNOUR,
City Clerk of The City of San Diego, California.

(Seal)

By Ellen Bovard, Deputy.

I HEREBY CERTIFY that the foregoing ordinance was not finally passed until twelve calendar days had elapsed between the day of its introduction and the day of its final passage, to wit, on SEP 23 1980, and on OCT 6 1980.

~~I FURTHER CERTIFY that said ordinance was read in full prior to its final passage.~~

I FURTHER CERTIFY that the reading of said ordinance in full was dispensed with by a vote of not less than a majority of the members elected to the Council, and that there was available for the consideration of each member of the Council and the public prior to the day of its passage a written or printed copy of said ordinance.

CHARLES G. ABDELNOUR,
City Clerk of The City of San Diego, California.

(Seal)

By Ellen Bovard, Deputy.

Office of the City Clerk, San Diego, California

Ordinance Number O-15353 Adopted OCT 6 1980

CC-1255-A (REV. 11-79)

EXHIBIT 12

MISSION STATEMENT

We pledge to continually deliver accurate and timely benefits through prudent administration and safeguarding of the San Diego City Employees' Retirement System, while ensuring the Fund's maximum safety, integrity and growth.

SDCERS RETIREMENT BOARD MINUTES
FRIDAY, APRIL 19, 2002

The Retirement Board of Administration held its regularly scheduled meeting in the System's Boardroom. Location: 401 "B" Street, Suite 400, San Diego, CA 92101. Fred Pierce called the meeting to order at 1:30 p.m.

IN ATTENDANCE:

Trustees: Frederick Pierce, Chair; John Casey, David Crow, Ray Garnica, Cathy Lexin, Mary Vattimo, Tom Rhodes, Ron Saathoff, Diann Shipione, John Torres, Terri Webster, Richard Vortmann, Sharon Wilkinson

Staff: Lawrence Grissom, Lori Chapin, Vincent Hayes, Sally Zumalt, Doug McCalla, Sheila Leone, Nancye Launer, Bernadette Stratton, Merlita Hilario, Sally Nadeau, Patrick Lane

Public: James Cunningham, Robert Blum, Kathy Ann Overcast, Garry Collins, Pamela Hightower, Matt Davis, George Wagner, Stan Elmore, Judy Folsom, Nancy Acevedo, Rick Roeder, Bob West, Stan Elmore

I. RATIFICATION OF GENERAL MEMBER BOARD REPRESENTATIVE ELECTION

Mr. Pierce congratulated Ms. Wilkinson on her re-election.

MOTION TO RATIFY ELECTION #45:	**J. CASEY**
SECOND:	**T. RHODES**
BOARD:	**UNANIMOUS**

MOTION PASSED UNANIMOUSLY.

II. APPROVAL OF CONSENT AGENDA ITEMS #A-I

MOTION TO APPROVE CONSENT AGENDA ITEMS #A-I:	**J. TORRES**
SECOND:	**S. WILKINSON**
BOARD:	**UNANIMOUS**

MOTION TO APPROVE PASSED UNANIMOUSLY.

A. SERVICE RETIREMENTS

1. Lewis R. Anderson III, Police Department, Police Officer II, 20.02 years creditable service. Age 55.36. Effective date 04/16/02. Estimated monthly allowance $3,436.80 plus $128.27 COLA, maximum benefit with surviving spouse provisions.

2. Dolores A. Cisneros, Water Department, Clerical Assistant II, 11.17 years creditable service. Age 62.00. Effective date 03/15/02. Estimated monthly allowance $588.41 plus $29.73 COLA, maximum benefit with no continuance. **(DEFERRED) (BOARD RULE 17C)**

3. Loretta P. Cory, Unified Port District, Administrative Assistant, Corporate Service, 20.07years creditable service. Age 62.34. Effective date 04/12/02. Estimated monthly allowance $2,089.49 plus $62.51 COLA, maximum benefit no continuance. **(ADDITIONAL FUNDS FROM SURVIVING SPOUSE MONIES)**

CONSENT AGENDA ITEMS A4-8 AND B1-5 PASSED UNANIMOUSLY. PAGE 1 REFLECTS THE VOTE.

4. Don J. Hargraves, Unified Port District, Engineer Technician II, 37.10 years creditable service. Age 64.42. Effective date 04/05/02. Estimated monthly allowance $3,938.24 plus $85.78 COLA, maximum benefit with surviving spouse provisions.

5. Borden Neece, Unified Port District, Lead Maintenance, 21.60 years creditable service. Age 56.39. Effective date 04/19/02. Estimated monthly allowance $2,203.30 plus $47.58 COLA, maximum benefit with surviving spouse provisions.

6. Beverly J. Smith, City Treasurer, Executive Secretary, 10.36 years creditable service. Age 62.00. Effective date 04/20/02. Estimated monthly allowance $609.90 plus $33.41 COLA, maximum benefit with surviving spouse provisions. **(DEFERRED)**

7. Robert J. Sullivan, Unified Port District, Harbor Police Officer, 19.00 years creditable service. Age 55.79. Effective date 04/20/02. Estimated monthly allowance $2,732.23 plus $165.34 COLA, maximum benefit with surviving spouse provisions.

8. Viola J. Williams, Park & Recreation Department, Administrative Aide II, 20.88 years creditable service. Age 58.90. Effective date 04/20/02. Estimated monthly allowance $1,696.55 plus $94.70 COLA, maximum benefit with no continuance.

B. APPROVAL OF ALTERNATIVE BENEFIT ACCRUALS – DROP THROUGH APRIL 9, 2002

1. Leslie G. Baran, Metropolitan Wastewater Department, Clerical Assistant II, 15.52 years creditable service. Age 66.86. Effective date 04/01/02. Estimated monthly allowance $1,088.51 plus $75.77 COLA, maximum benefit with no continuance.

2. Richard Flores, Metropolitan Wastewater Department, Instrumentation & Control Supervisor, 24.83 years creditable service. Age 61.00. Effective date 03/30/02. Estimated monthly allowance $2,854.06 plus $105.54 COLA, maximum benefit with surviving spouse provisions.

3. Patrick J. Shanley, Police Department, Police Detective, 21.32 years creditable service. Age 55.42. Effective date 04/08/02. Estimated monthly allowance $3,740.86 plus $145.70 COLA, maximum benefit with surviving spouse provisions.

4. Louis A. Tamagni, Police Department, Police Detective, 21.44 years creditable service. Age 50.00. Effective date 03/25/02. Estimated monthly allowance $3,127.10 plus $94.86 COLA, reduced benefit, with surviving spouse provisions. **(OPTION II)**

5. Howard C. Williams, Police Department, Police Sergeant, 30.01 years creditable service. Age 51.50. Effective date 03/20/02. Estimated monthly allowance $5,809.46 plus $158.74 COLA, maximum benefit with surviving spouse provisions.

CONSENT AGENDA ITEMS C1-H PASSED UNANIMOUSLY. PAGE 1 REFLECTS THE VOTE.

C. SPECIAL DEATH BENEFIT

1. Payment to Jill A. Murray, widow of James R. Hull, Fire Department, Firefighter. 17.16 years creditable service. Effective date 11/25/01. Estimated monthly continuance $2,759.05.

D. DISPENSE WITH THE READING AND APPROVAL OF THE 03/15/02 MINUTES

E. APPROVAL OF SDCERS' TRUST FUND FINANCIAL STATEMENTS FOR 02/28/02

F. STATEMENTS OF MEMBERSHIP THROUGH APRIL 9, 2002

Active	Retired (including DROP's)	Enrolled	Withdrawals	Deaths (DPS)	Retired (less widows)	Retired Deaths	1981 Pension Plan
11,035	5,977	90	13	1	12	15	2

G. ENROLLMENTS IN DROP THROUGH MARCH 31, 2002

MEMBERSHIP CATEGORY	NUMBER ENROLLED	MEMBERSHIP CATEGORY	NUMBER ENROLLED	TOTAL DROP PARTICIPANTS
GENERAL	351	UPD GENERAL MEMBER	4	
POLICE	261	LEGISLATIVE	1	838
FIRE	221	LIFEGUARD	0	

H. WITHDRAWALS OF CONTRIBUTIONS THROUGH APRIL19, 2002

NAME	DEPARTMENT	REASON	AMOUNT
S. Kurzenski	Police	Refund of Contributions	45,681.59
		Death Benefit	23,126.82
		SUBTOTAL	68,808.41
Chris Chaney	Police	Quit	$ 33,559.56
Tom Kim	Fire	Quit	266.41
Mark Bisson	Metro Wastewater	Quit	12,983.54
Judith Bisson	Metro Wastewater	Quit	12,690.49
Thomas Purcell	Park & Recreation	Quit	3,025.94
Darrell Jennings	Park & Recreation	Quit	2,858.51
Toni Hund	Water Utilities	Quit	5,227.38
Darron Lee	Metro Wastewater	Quit	2,677.82
Kelly Owen	Metro Wastewater	Quit	6,103.27
Mark Fendrich	Police	Quit	21,372.48
Dale Davis	General Services/Streets Div	Quit	20,633.16
Tim Coder	Park & Recreation	Quit	16,628.60
Dietra Hughes	General Services/Streets Div	Quit	6,944.89
		TOTAL	213,780.46

CONSENT AGENDA ITEM I PASSED UNANIMOUSLY. PAGE 1 REFLECTS THE VOTE.

I. DROP RETIREMENT DISBURSEMENTS THROUGH APRIL 27, 2002

Weshley R. Ascraft	Police Sergeant	Remain on account	03/30/02
Ralph E. Basquez	Heavy Truck Driver	Remain on account	03/30/02
Richard W. Bennett	Police Lieutenant	Remain on account	03/30/02
David A. Buck	Fire Captain	Remain on account	04/01/02
Michael J. Burleigh	Airport Operations Technician	Remain on account	04/01/02
Gerald A. Cannon	Battalion Chief	Remain on account	04/01/02
Donald E. Cevera	Associate Civil Engineer	Remain on account	04/30/02
Antonio Diaz	Equipment Technician I	Remain on account	04/13/02
Maurice Gonzales	Welder	Remain on account	04/20/02
Tappin A. Gorman Jr.	Fire Captain	Remain on account	04/01/02
Susan K. Hays	Police Officer II	Remain on account	04/02/02
James J. Hunter	Fire Battalion Chief	Remain on account	04/01/02
Daniel A. Ignosci	Fire Captain	Remain on account	04/01/02
Lawrence J. Lindstrom	Police Detective	Remain on account	04/27/02
Peter A. Lopez	Deputy Director	Remain on account	04/02/02
Eduardo T. Medina	Police Detective	Remain on account	04/15/02
Herman G. McFeely, Jr.	Fire Engineer	Remain on account	04/01/02
Irene M. Mershon	Senior Typist	Remain on account	04/01/02
Jerry K. Northcutt	Fire Captain	Remain on account	04/01/02
Robert E. Osby	Fire Chief	Remain on account	04/01/02
Dale M. Partusch	Fire Engineer	Remain on account	04/01/02
Thomas J. Payne	Police Sergeant	Remain on account	04/27/02
Jack Powell	Building Maint. Supervisor	Remain on account	04/01/02
Thomas Quijencio	Fire Engineer	Remain on account	04/27/02
Gary W. Reichle	Police Detective	Remain on account	03/30/02
Charles R. Rivas	Fire Engineer	Remain on account	04/01/02
Oran L. Shadoan	Fire Engineer	Remain on account	03/31/02
Stuart H. Swett	Senior Deputy City Attorney	Remain on account	04/01/02
Thomas E. Trainor	Deputy Director	Remain on account	04/01/02
David A. Ytreus	Firefighter	Remain on account	04/04/02

III. APPLICANT'S ATTORNEY REQUEST TO REFER INDUSTRIAL DISABILITY RETIREMENT APPLICATIONS TO AN ADJUDICATOR

1. Edward Johnson, Water Utilities, Laborer.

BASED ON THE APPLICANT'S ATTORNEY'S REQUEST, MOTION TO REFER THIS APPLICATION TO AN ADJUDICATOR: J. CASEY
SECOND: D. CROW
BOARD: UNANIMOUS
MOTION PASSED UNANIMOUSLY.

IV. STAFF RECOMMENDATION TO DENY INDUSTRIAL DISABILITY RETIREMENT APPLICATIONS

1. Kathy A. Overcast, Unified Port District, Maintenance Worker. 2.93 years of creditable service. Age 43.57. Effective date 05/18/01. Estimated monthly allowance $760.23 plus $4.21 COLA, maximum benefit with no continuance. **(ADDITIONAL FUNDS FROM SURVIVING SPOUSE MONIES)**

BASED ON STAFF'S RECOMMENDATION AND ON THE MEDICAL REPORTS, MOTION TO DENY: D. CROW
SECOND: D. VORTMANN
DISCUSSION:

Attorney Matthew Davis asked the Board to reconsider its motion to deny. He stated Ms. Overcast initially experienced back pain in July 1999 as the result of having to move heavy furniture and wall dividers for the Port District as a Maintenance Worker. She experienced debilitating back pain in September 1999 after operating a 90-pound jackhammer, in which she sought medical treatment. Staff's recommendation for denial seems to be based on one doctor's opinion that she had a degenerative disease in her lower back. However, Dr. Larry Dodge indicates that Ms. Overcast suffers from chronic, reoccurring lumbar sacral strain. Her chiropractor, Dr. Frazier, put work restrictions on her that included no lifting of over 25 pounds, no repetitive bending, stooping or twisting, which Dr. Lane agreed with. As to the industrial nature of the disability, Dr. Frazier found that this was industrially related and Dr. Dodge stated that the patient's current symptoms and disabilities are related to the industrial injury in question. Dr. Lane opined that Ms. Overcast's symptoms were a flare up of her previous industrial injury from July 1999. In addition, the Port District sent Ms. Overcast home in January 2001, based on several reports of an ergonomic specialist who found her unable to do her job anymore. For these reasons, he asked that the Board grant the industrial disability application or to refer the matter to an adjudicator.

SUBSTITUTE MOTION TO REFER THIS CASE TO AN ADJUDICATOR: R. SAATHOFF
SECOND: J. CASEY

DISCUSSION:

Ms. Wilkinson said she would like to hear from the Board's medical specialist, Nancye Launer.

Ms. Leone replied that Ms. Launer is not here today. However, she has some understanding of this case. She understands that this is a degenerative condition of a very short-term employee with no specific injury that would have been severe enough to cause the condition in her back. The Board's certified orthopedic surgeon has given an opinion that there is no way that over this short term with no specific injury that back pain of this severity could have been the result of her job.

Ms. Wilkinson said under the Board's rules, if there is a conflict in the medical records, these cases will be sent to an adjudicator. In her additional read of the reports, she didn't recognize the conflict. However, in hearing Attorney Davis's comments, she would support the substitute motion to refer this to an adjudicator.

Ms. Shipione said she would support the substitute motion to refer this to an adjudicator. She would also support a motion to continue this 30-days so Ms. Launer could address the Board at the next meeting.

Attorney Davis said he believes this case has already been continued twice and he believes he has exhausted his requests for continuance pursuant to the Board's rules.

Ms. Pierce stated the Board could clearly waive its rules in this case.

Attorney Davis said he would like to see this move forward.

Mr. Casey said he would agree with referring this to an adjudicator because of the apparent conflict in medical records.

Mr. Saathoff agreed.

CALL FOR THE SUBSTITUTE MOTION TO REFER MS. OVERCAST'S INDUSTRIAL DISABILITY APPLICATION TO AN ADJUDICATOR.

BOARD: 12 IN FAVOR: J. CASEY, T. RHODES, M. VATTIMO, D. CROW, F. PIERCE, R. SAATHOFF, R. GARNICA, S. WILKINSON, D. SHIPIONE, J. TORRES, T. WEBSTER, D. VORTMANN
1 OPPOSED: C. LEXIN
MOTION TO REFER TO AN ADJUDICATOR PASSED 12 TO 1.

V. ADJUDICATOR'S FINDINGS OF FACT AND RECOMMENDATION TO APPROVE INDUSTRIAL DISABILITY APPLICATIONS

1. Christopher Barker, Streets Division Heavy Truck Driver II, 15.26 years creditable service. Age 46.27. Effective date 10/21/00. Estimated monthly allowance $1,572.20 plus $24.06 COLA, maximum benefit with surviving spouse provisions. **(BOARD RULE 17A)**

BASED ON THE ADJUDICATOR'S FINDINGS OF FACT AND RECOMMENDATION,
MOTION TO APPROVE: **D. CROW**
SECOND: **J. TORRES**
BOARD: **UNANIMOUS**
MOTION TO APPROVE PASSED UNANIMOUSLY.

VI. ADJUDICATOR'S FINDINGS OF FACT AND RECOMMENDATION TO DENY INDUSTRIAL DISABILITY APPLICATIONS

1. George Wagner Jr., Real Estate Assets, Carpenter. 12.21 years creditable service. Age 54.39. Effective date 03/04/00. Estimated monthly allowance $1,792.03 plus $45.10 COLA, reduced benefit with 100% continuance to beneficiary. **(OPTION II).**

MOTION TO ADOPT THE ADJUDICATOR'S FINDINGS OF FACT AND RECOMMENDATION TO DENY MR. WAGNER'S INDUSTRIAL DISABILITY APPLICATION: **S. WILKINSON**
SECOND: **D. CROW**

DISCUSSION:
Attorney James Cunningham spoke against the motion to deny. He stated that this case involved a question with Dr. Hackley, who the Board questioned for his lack of reporting at the hearing before Judge Duffy. Dr. Hackley testified under oath that the applicant worked seven days a week, lifting up to 300 pounds at a time, etc., until Mr. Cunningham questioned him whether he knew this to be fact or if he was speculating. Dr. Hackley admitted that he was speculating. He also testified at the trial and in his medical report that the applicant at the time he was examined had been working for the past 13 months as a Carpenter, wearing orthodics. At that point in time, Mr. Wagner had not been working and had already been through the vocational rehabilitation program resulting from the Worker's Compensation claim. Dr. Hackley testified and Judge Duffy relied upon Dr. Hackley's testimony. Mr. Cunningham said he was very disturbed at Judge Duffy's two page finding on a full day's trial. Judge Duffy's opinion on Page 2 states that he believes the applicant could continue working unrestricted on his job, as outlined in Exhibit #9. However, Mr. Wagner wasn't working on his job at the time of the trial, nor was he working full duty at the time Dr. Hackley examined him. It is obvious that Dr. Hackley was not prepared at the trial, nor was he in a position to render an opinion regarding Mr. Wagner's disability. Unfortunately, Judge Duffy relied upon his report and testimony. For this reason, the Board had continued this case until today so it would have the opportunity to review the transcripts. He added that he received a fax from Staff a few days ago that indicated the City is holding a position open for Mr. Wagner. However, there is nothing that states they will allow him to return with his work restrictions.

Ms. Leone agreed that Dr. Hackley was not a good witness. To say that he was not prepared to render an opinion is false. She stated that Dr. Behr, who is an orthopedic surgeon, examined Mr. Wagner one month after he stopped working and rendered an opinion that Mr. Wagner was completely normal under his examination and did not require any work restrictions. In addition, Mr. Wagner's MRI was totally normal. She agreed that Dr. Hackley wasn't prepared to testify. She has spoken to him and written to him about her dissatisfaction. A Trustee has also written to him about her dissatisfaction. However, the MRI is what it is. The Judge's opinion is short because the applicant is not disabled and failed to sustain his burden of proof. The reason she distributed the Department Director's memo stating they are holding a job for Mr. Wagner is to show that he is not in a "catch-22" position.

In a regular trial, Ms. Wilkinson asked what the rules are with regards to retrying a case if mistakes of fact were made at the original hearing or trial.

Ms. Leone said the mistakes of fact were in Dr. Hackley's testimony. His testimony was factually erroneous. However, she doesn't believe there were any mistakes of fact with the MRI, which does not support Mr. Wagner's injury. Therefore, she doesn't believe there is anything to retry. The judge's job is to look at the facts, which he did. He also reviewed and overruled Mr. Cunningham's objections and stated in his supplemental decision that he basically concurred with Staff's papers. She reiterated that Dr. Behr and Dr. Colson's reports support Judge Duffy's decision to deny this case. As for a trial court, Ms. Leone said there are no rules that she is aware of for retrying a case.

Attorney Cunningham said if the Board denies this case, it will end up in Superior Court. The only remedy for the Superior Court is to determine whether Mr. Wagner provided the preponderance of the evidence and whether he had the medical evidence to support his claim. If Superior Court determines that Dr. Hackley's report was not substantial, it will be removed from the record. If the judge relied upon imperfect and disingenuous testimony, then Judge Duffy's opinion will hold as much weight as Dr. Hackley's opinion. As a means to avoid additional financial hardship to Mr. Wagner, he would recommend that the Board continue this 30-days to give Trustees the opportunity to review the evidence prior to voting.

Ms. Wilkinson said she would be more inclined to refer this back to Judge Duffy to resolve the factual evidence.

Attorney Cunningham said he had provided his objections to Judge Duffy, which were overruled. However, he doesn't believe the judge spent much time reviewing his objections and did not attempt to correct the record.

Mr. Saathoff said it doesn't seem the transcript would provide much information. Therefore, this will ultimately end up in Superior Court. Regarding the "catch-22" issue, he indicated that the Department Director's letter doesn't state they are willing to bring Mr. Wagner back to work with his work restrictions, only that they are holding this job open. He asked if the City has cleared Mr. Wagner for full duty. If so, he would support the motion to deny this case. If not, he can't support the motion.

Ms. Leone replied that Mr. Wagner could return to work if he would like to. The Board's medical evidence has shown that there is no disability. If the job is there and the Department Director has said he can return to work, there is no reason the Board should grant this disability or refer it back to the adjudicator.

Mr. Saathoff said if the City says Mr. Wagner can return to his job based on the Worker's Compensation records, he would be happy to support the motion to deny. If not, he won't support the motion to deny.

Attorney Cunningham referred to a document dated 1/25/00 that was sent from Mario Sierra, the Assistant Department Director at that time, to Mr. Grissom indicating that Mr. Wagner cannot return to work with his work restrictions. He clarified that there is no medical clearance for Mr. Wagner to return to work.

Mr. Pierce reminded Mr. Saathoff that there are different standards between this Board and the City. Whether the Board likes this or not, it is a fact. Therefore, the fact that the City is or isn't prepared to return Mr. Wagner to work is not relevant for this Board. It is a breech of the Board's fiduciary duty to pay a benefit to a member who hasn't proven he is disabled.

Mr. Saathoff said he would like the opportunity to review the transcripts to determine whether the City will allow Mr. Wagner to return to work.

Ms. Shipione said she would vote against the motion to deny because the Board's doctor failed to do his job. She asked if this case could be referred to a different adjudicator.

Ms. Chapin replied, "No." To do so would be considered judge shopping, which is inappropriate. Just because there was a bad witness doesn't give the Board the authority to grant a disability.

Attorney Cunningham agreed with Ms. Chapin.

Ms. Chapin stated that there was other medical evidence that didn't support the disability.

Ms. Shipione suggested that a clean hearing might be appropriate in this case.

Ms. Chapin said the Board could refer the applicant to another physician, which has never done before. If this were to occur, the new physician's report could be forwarded to Judge Duffy for further consideration.

Ms. Shipione would support doing this because of Dr. Hackley's poor testimony.

Ms. Lexin asked if the Board has the discretion to consider what goes on in the Worker's Compensation process. She stated that she would assume that the Board's legal counsel would concur with Mr. Pierce's comment.

Ms. Chapin said she agrees with Mr. Pierce.

Mr. Vortmann said he doesn't understand the relationship between the City clearing this employee to return to work and whether this is an actual industrial disability. These are two separate issues.

Mr. Saathoff said Worker's Compensation would not render an employee qualified for vocational rehabilitation unless it found them to be disabled. The Board doesn't have the same standard as the City. If the City states the employee is cleared to return to full duty, there is no question that the employee is not disabled. However, if the City won't clear the employee, then there has been a finding of a disability under Worker's Comp. law.

With the discrepancies and confusion raised today, Mr. Crow stated it might be appropriate to continue this case 30-days so the Board can review the transcript.

SUBSTITUTE MOTION TO CONTINUE 30-DAYS: **D. CROW**
SECOND: **R. SAATHOFF**

DISCUSSION:
Ms. Leone clarified that the reason she brought the memo from the Department Director forward was to show that Mr. Cunningham's representation that there is no job for Mr. Wagner is false. The Board needs to be aware of the facts in this case. She reminded the Board that Mr. Wagner must meet his burden of proof, which he did not do. The MRI did not show anything wrong with Mr. Wagner, nor did a podiatrist and two orthopedic surgeons. The Department Director's memo further shows that the City is holding his job open.

Mr. Cunningham stated that an MRI wouldn't show that someone is having pain in his or her calf. He agreed that the Board should continue this to review the transcript. He added that every doctor, with the exception of Dr. Hackley, believes there is something wrong with Mr. Wagner.

Mr. Vortmann said he would vote against a continuance unless the Board provides the criteria for doing so.

Mr. Saathoff said he would like to read the transcript prior to voting. He doesn't expect another Staff report, but would like Staff to address whether the City has a job for Mr. Wagner with his work restrictions.

Ms. Leone said the Department Director's memo states they are holding his job open.

Mr. Casey said an MRI isn't necessarily the best criteria for determining whether an employee is disabled.

Ms. Shipione said she would like Mr. Wagner referred to a different physician. She questioned if she could make this as a motion.

Ms. Chapin said a motion to continue takes precedence.

CALL FOR THE SUBSTITUTE MOTION TO CONTINUE 30-DAYS.

BOARD: 8 IN FAVOR: T. RHODES, D. CROW, R. SAATHOFF, J. TORRES, T. WEBSTER, D. SHIPIONE, D. VORTMANN, J. CASEY
5 OPPOSED: M. VATTIMO, F. PIERCE, R. GARNICA, S. WILKINSON, C. LEXIN
MOTION TO CONTINUE PASSED 8 TO 5.
(Please note: the electronic voting system reflected Mr. Casey as a no vote. He asked that the final minutes be corrected to reflect his vote as yes.)

VII. ADMINISTRATIVE STATUS REPORTS: INVESTMENTS, LEGAL, OPERATIONS

Mr. Grissom said Staff had been asked that the Earnings Subcommittee continue to do its work on this issue.

Ms. Webster referred to the Operations Status Report, stating she had asked last month for a monthly update on the overpayments of the System. She also stated that there are 183 individuals being underpaid. She would like a timeline for when Staff expects to have these corrected.

Mr. Barnett said he would like to meet with Ms. Webster to determine what exactly is needed.

On the same report, Ms. Wilkinson referred to the status of the recalculations on the high one-year methodology for purchase of service contracts. She stated there was no Board decision on how these would be calculated and she's unclear as to what the high one-year is. She was surprised that the recalculations are going on since the Board hasn't made a decision on this.

Mr. Grissom said this came out of the Audit Report, which asked Staff to change its procedures. Staff used to use 26 pay periods to calculate these and then switched to calculate on a day-to-day basis, which provides a slightly higher one-year salary. In last month's discussion, Staff agreed to follow the recommendation of the Audit Report.

Ms. Wilkinson said this wasn't a Board decision. Therefore, she asked that it be a future agenda item. She clarified that Staff is currently calculating this on a day-to-day basis.

Ms. Vattimo asked if there are actually 183 retirees being underpaid.

Mr. Grissom replied, "Yes." However, he explained that the amounts are not material, as the highest underpayment was $400 per year."

Ms. Vattimo agreed with Ms. Webster that it is important to have a timeline in place to correct these calculations.

Ms. Shipione referred to the Legal Report. She asked if George Hoffman had asked to rejoin DROP and return to work.

Ms. Chapin replied that he had withdrawn his disability application and asked to return to work.

Ms. Chapin stated that the Legal Report included information on Kenneth Offenbach. After reviewing his file more carefully, Staff determined that he was not eligible to apply for a deferred service retirement because of the date he was hired. This has been communicated to Mr. Offenbach along with information that he could appeal Staff's decision. To date, nothing has happened.

Ms. Wilkinson asked if deferred members are not eligible for a service retirement.

Mr. Grissom said this is correct for deferred members who are not vested.

BUSINESS PROCEDURES COMMITTEE REPORT – RON SAATHOFF, CHAIR

1. STATUS REPORTS

A. **NO ACTION REQUESTED**

1. UPDATE ON SDCERS STAFFING VACANCIES

   Mr. Saathoff said Staff's report was included in the packet.

2. REPORT ON ETHICS COMMISSION

   Mr. Saathoff commended Staff on their report. He stated that two issues were addressed, one which could be addressed through the Board's contract language. Staff is further researching this and will bring the information forward in the next few months.

   Ms. Shipione asked if the Committee has considered recommending that the Rules Committee draft a policy that would include potential conflicts of interest in the contract language.

   Ms. Chapin said there is already a Board Rule on this, which could be further reviewed.

Mr. Saathoff said compensated versus non-compensated Board members would also be included in Staff's research.

Ms. Chapin stated that Board Rule 1.00 generally discusses the issue raised by Ms. Shipione regarding conflict of interest.

Ms. Shipione said she would like the Rules Committee to further articulate the language.

Mr. Garnica stated appointed Board positions are voluntary. Therefore, he'd be against any prohibition for Trustees to do business with outside companies. He would support language that would prevent any appearance of a conflict of interest.

Mr. Saathoff agreed that this should be reviewed.

Ms. Lexin commented on the statement that no trustees are compensated, which is incorrect. City employees who are also Trustees are compensated for the time they spend on the Board.

Ms. Chapin agreed. However, the appointed members do not have the revolving door provisions because they aren't compensated, which should be looked at.

Ms. Lexin asked if the Board members who are elected or are ex officio members of the Board are considered compensated. She would be concerned about the language making it difficult for people to serve on the Board. If the Board President awarded a contract to a firm and then went to work for that firm the following week, she would have a problem with the apparent conflict. She stated that there is a very detailed Council policy and Administrative Regulation on the conflict of interest code, which applies to all City employees.

Mr. Vortmann said there should be a formal Board policy that all trustees sign each year stating they are aware of the policy.

Ms. Shipione said full disclosure should also be a part of the policy. This goes hand in hand with the conflict code and should be agreed to by Board members, Staff, vendors and consultants.

Ms. Lexin said she would encourage the Board not to try to impose its own policy with regard to this, stating there are already plenty of protections in place with the current policies.

In its review, Staff was directed to review the current policies along with Staff relationships with regard to this.

3. STATUS ON GENERAL MEMBER REPRESENTATIVE RETIREMENT BOARD TRUSTEE ELECTION

Mr. Saathoff congratulated Ms. Wilkinson on her re-election.

4. NOTICE OF OVERPAYMENTS OVER $5,000

A) VIRGINIA BATSELL
B) PERCY L. WALTERS

Ms. Webster stated she wants a timeline on when these will be resolved. She also asked Staff to include information on any weaknesses in controls that allowed this to happen. In addition, she asked that all Staff be informed of the Board's policy regarding the reporting of overpayments, as one of these happened approximately fourteen months ago.

2. OLD BUSINESS

A. ACTION REQUESTED

1. RECOMMENDED APPROVAL OF ANNUAL COLA ADJUSTMENTS

EFFECTIVE JULY 1, 2002, MOTION TO APPROVE THE COLA INCREASE OF 1.8% FOR 1981 PENSION PLAN RETIREES; 2.0% FOR ALL ELIGIBLE PRE 07/01/01 SDCERS RETIREES AND 1.6% FOR ALL ELIGIBLE POST 06/30/01 SDCERS RETIREES, WITH SPECIAL CLASS SAFETY FLUCTUATORS BEING EXEMPT FROM THIS INCREASE: **R. SAATHOFF**
SECOND: **J. TORRES**
BOARD: **UNANIMOUS**
MOTION TO APPROVE PASSED UNANIMOUSLY.

Ms. Shipione said she hates for the System to incur further debt, but believes this increase is long overdue.

2. RECOMMENDED APPROVAL OF SDCERS' FY '03 BUDGET

Mr. Saathoff stated that the budget and the actuarial valuations were trailed to May 2002.

3. APPROVAL OF SDCERS ACTUARIAL VALUATION DATED 06/30/01 AND UPD'S VALUATION DATED 06/30/01

Trailed to May 2002.

4. REVIEW AND RECOMMENDATIONS REGARDING SDCERS' CURRENT CONTRACTS

Mr. Saathoff said this item is to come back with Staff to provide information on both finances and on how these vendors are performing along with recommendations as to whether these services should be continued or if replacement vendors are necessary.

Ms. Shipione said she wants consideration given to include language in the contracts that would require full disclosure of vendors and consultants, including apparent conflicts, legal suits filed against them, etc.

Mr. Vortmann asked what the strategic planning services contract related to.

Mr. Pierce stated a consultant had been hired to meet with the Board and Staff on a few occasions, which resulted in the member survey being mailed. It is anticipated that the consultant will be brought back in once the results of the survey have been tallied.

5. RECOMMENDED REVISIONS TO DIVISION 14 OF THE RETIREMENT BOARD RULES AND SAN DIEGO MUNICIPAL CODE REGARDING DEFERRED RETIREMENT OPTION PLAN (DROP)

MOTION TO APPROVE STAFF'S RECOMMENDED LANGUAGE FOR PERIODIC DISTRIBUTIONS OF THE DROP ACCOUNTS AND FOR THE PROCEDURES TO DO SO WITH CLARIFICATION ON THE INTEREST RATE TO COME FROM MR. BLUM: **R. SAATHOFF**

SECOND: **M. VATTIMO**

DISCUSSION:

Ms. Chapin said the interest is the interest rate in place on the date an employee leaves DROP. It cannot be lesser than 5% or whatever the actuarial rate is that the Board sets. A member's DROP interest rate will stay at whatever it was at the time they leave DROP. However, if the Board were to later raise the assumed interest rate, the DROP member's interest rate would remain at the lower rate. If the Board were to lower that interest rate at sometime in the future, the member's DROP interest rate could either be lowered or remain the same.

Mr. Saathoff said the way the DROP plan was originally written, the interest rate was based on the assumed interest rate of the System, which could fluctuate up or down relative to the assumption rates of the System. What he has heard Mr. Blum state is that if a member leaves SDCERS at the end of their DROP period, whatever interest rate is being paid at that point in time is locked in, unless the Board lowered its interest rate. If this were to happen, the member's DROP account interest could be lowered at that time, but not below 5%.

Ms. Lexin said this is not what was negotiated.

Mr. Saathoff said if the assumed interest rate goes up, the member's DROP interest rate remains the same once they've left DROP. However, their interest rate can be lowered with the System's interest rate from what it was when they left, but not below 5%.

Mr. Blum said this is a condition of the Board being able to pay periodic payments. For some time, Staff has asked if periodic payments would be allowed from DROP accounts for those who have already retired. He stated that periodic payments are tough to do because of the 415 laws. However, periodic payments can be paid and administered so long as there is a cap on the interest rate paid for those who have already terminated.

Ms. Webster said not all members would receive the same interest rate at the same time.

Mr. Blum said this is correct under the law. However, the alternative is much worse.

Ms. Lexin asked if the Board has the discretion to set different assumption rates from the actuarial amount.

Mr. Blum stated that per the Municipal Code, the amount credited to the DROP accounts is at a rate determined by the Board. This could be a part of today's earnings discussion, but he believes it would be appropriate for the Board to do this. Prospectively, the question is whether the Board could make this change. This is a fiduciary decision, which would require lengthy evaluation.

Mr. Casey asked if the caps and limitations are limited to those wanting payments from their DROP account.

Mr. Blum said he believes those leaving their money in their DROP account would also be subject to limitations. However, this would require further review, as it has to do with 415 calculations. There does, however, have to be a cap on the interest rate.

CALL FOR THE QUESTION TO APPROVE.

BOARD: **UNANIMOUS**
MOTION TO APPROVE PASSED UNANIMOUSLY.

3. HEALTH ADVISORY COMMITTEE REPORT – D. CROW, CHAIR

1. STATUS REPORTS

A. NO ACTION REQUESTED

1. RETIREE COMMUNICATIONS

Mr. Crow reported that three communications had been received. Two have been answered and Staff is researching the third.

NEW BUSINESS

A. NO ACTION REQUESTED

1. REPORT ON HEALTH CARE RFP PROCESS

Mr. Crow said this item was continued to May because negotiations are not yet finalized.

INVESTMENT COMMITTEE REPORT – MARY VATTIMO – CHAIR

1. STATUS REPORTS

A. NO ACTION REQUESTED

1. VENDOR'S WATCH LIST
2. SDCERS' ASSET ALLOCATION STATUS
3. SDCERS' SECURITIES LENDING PROGRAM 1.,4 million through March 5th.
4. STATUS ON DUE DILIGENCE OF GMO AND NICHOLAS APPLEGATE
5. RUSSEL REAL ESTATE ADVISORS PERFORMANCE REPORT THROUGH 12/31/01

Ms. Vattimo reported: 1) Putnam would be added to the Watch List for significant personnel changes; 2) all allocations are tracking within range; 3) the securities lending program as of March 5th had returned $1.4 million; 4) both GMO and Nicholas Applegate had passed due diligence; and, 5) the real estate portfolio generated a return of 2.8% for the quarter and 10.2% year-to-date.

Ms. Shipione noted that there had been discrepancies between Callan and Russell's reporting by approximately 20%. She stated that she had asked Callan to disclose on each page of their report where their numbers are based on the custodial bank. Callan agreed to do this going forward.

Ms. Wilkinson asked if there are citations as to what sources Callan uses to derive their numbers.

Mr. Grissom clarified that Callan's quarterly real estate report lags the actual real estate report because they base their numbers on the custodial bank. It takes the bank longer to get the actual real estate numbers than it does for Russell, who gets their numbers directly from the managers. However, Callan does go back and correct their reports once they receive the actual numbers from Russell.

2. OLD BUSINESS

A. ACTION REQUESTED

1. REVIEW AND IDENTIFICATION OF LARGE CAP GROWTH DOMESTIC EQUITY MANAGERS FOR A SELECTION INTERVIEW PROCESS

Ms. Vattimo stated the Committee had selected three firms to interview next month, which will begin at 1:00 p.m. In addition, the Committee will discuss a short list in the mid cap core value area next month.

Ms. Shipione reported her surprise to learn that all of the managers being recommended for interview by Callan had some financial relationship with them. She added that Mr. Callahan had respectfully refused to provide her with some information she had asked for. Therefore, she will be asking, if there are no objections from the Board, for a list of the 399 managers Callan originally looked at.

2. REVIEW AND IDENTIFICATION OF MID CAP CORE VALUE DOMESTIC EQUITY MANAGERS FOR A SELECTION INTERVIEW PROCESS

Trailed to May 2002.

3. NEW BUSINESS

A. ACTION REQUESTED

1. RECOMMENDED APPROVAL OF THE ASSIGNMENT OF RREEF'S REAL ESTATE MANAGER AGREEMENT TO DEUTSCHE ASSET MANAGEMENT

MOTION TO APPROVE: **M. VATTIMO**
SECOND: **R. SAATHOFF**

DISCUSSION:
Ms. Shipione said she had asked Staff to research how many of the Board's managers are now owned by international firms.

BOARD: 12 IN FAVOR: M. VATTIMO, R. SAATHOFF, D. CROW, J. CASEY, T. WEBSTER, F. PIERCE, T. RHODES, R. GARNICA, D. VORTMANN, J. TORRES, C. LEXIN, S. WILKINSON
1 OPPOSED: D. SHIPIONE
MOTION TO APPROVE PASSED 12 TO 1.

2. RECOMMENDED APPROVAL OF SDCERS 2002-2004 REAL ESTATE STRATEGIC PLAN ELEMENTS AND IMPLEMENTATION PLAN

MOTION TO APPROVE STAFF'S RECOMMENDED 2002-2004 REAL ESTATE STRATEGIC PLAN WITH THE IMPLEMENTATION PLAN TO COME BACK FOR ACTION AT A LATER DATE: **M. VATTIMO**
SECOND: **R. SAATHOFF**

DISCUSSION:
Ms. Shipione said she is concerned about this shift because it takes cash that could be used at some point to potentially assist with the surplus earnings issue. For this reason, she will vote against the motion.

CALL FOR THE QUESTION TO APPROVE THE REAL ESTATE STRATEGIC PLAN.

BOARD: 12 IN FAVOR: M. VATTIMO, R. SAATHOFF, D. CROW, J. CASEY, T. WEBSTER, F. PIERCE, T. RHODES, R. GARNICA, D. VORTMANN, J. TORRES, C. LEXIN, S. WILKINSON
1 OPPOSED: D. SHIPIONE
MOTION TO APPROVE PASSED 12 TO 1.

RULES COMMITTEE REPORT – JOHN TORRES, CHAIR

A. ACTION REQUESTED

1. RECOMMENDED BOARD COMMUNICATIONS POLICY

Mr. Torres said there was no action on this item. However, the Committee referred this back to Staff to look at issues with regard to the language as it pertains to the Board and Staff, which will come back for action next month.

Ms. Shipione said she feels strongly that a public Board and its trustees should be able to speak freely to anyone. In her opinion, it would be inappropriate to tell trustees that they can't talk to the press. Any policy that would restrict trustees in this area she would oppose. She also questioned whether such a policy could be legally enforceable. She would support any trustee being able to speak to the public.

Ms. Wilkinson said the Committee raised the same concerns.

Mr. Rhodes said as long as the Board prefaces that these are personal comments and do not represent the Board as a whole he would agree.

Ms. Chapin said if a trustee is speaking for the Board, this is a different issue.

Mr. Casey said he believes the Board President and Retirement Administrator should be the general spokesperson for the Board.

Mr. Torres said the Committee didn't believe the Board Rule should include Staff.

VIII. PUBLIC COMMENT

Mr. Elmore spoke to the Board's agenda. He stated that public comment used to be listed after closed session. At his request, he stated Staff had changed that to fall before Closed Session because he felt it discouraged the public from making comments. In his opinion, all public business should be taken care of before closed session. He was disappointed to see the earnings issue as the last item of business today.

For purposes of today's meeting, Mr. Pierce said he would take the earnings issue out of order.

IX. QUESTIONS & COMMENTS FROM PRESIDENT, TRUSTEES, ADMINISTRATOR ATTORNEY – None.

X. CLOSED SESSION – None.

XI. ADMINISTRATOR'S PERFORMANCE REVIEW

This item was trailed to the May 2002 meeting.

XII. RECOMMENDATIONS AND REQUESTED ACTION FROM THE SUBCOMMITTEE REGARDING EARNINGS

Mr. Pierce said this is a very important issue this year. As such, a Subcommittee was formed to address the issues and has met on several occasions. He asked that the Board allow Staff to fully present the Subcommittee's report before asking questions and to reserve their comments to the end.

Mr. Grissom provided a detailed presentation of the Subcommittee's review and recommendations. A copy of his presentation material is included as Attachment A of these minutes.

Mr. Pierce said when the Committee was formed; one of the things the Board had asked was what its legal authority is with respect to earnings under the Municipal Code. On the advice of fiduciary counsel, the Committee took into consideration what actuarial implications any of its recommendations would have on the fund and which of these actions would serve to dilute the funded ratio of the system. The Committee looked at this while taking into consideration the Board's comments that it wanted to send a clear message that it would no longer finance benefits formulated under the Manager's Proposal. Currently, the actuarial employer contribution rate is at 15% and the System is closer to receiving 10%, which increases at 50 basis points per year. This is the ten or eleven years discussed by Mr. Grissom. If the Board overlays some of these actions to dilute the funded ratio, the projections could go from 15% to 19% and it could be anywhere from 15 to 20 years out before the cross over under the Manager's Proposal occurs. As he understood at the recommendations of the Subcommittee, the following items would essentially reduce the funded ratio of the System: 1) crediting of the interest on the DROP accounts as a vested benefit, which is a requirement of the Municipal Code, which is about $5 million; 2) funding the budget if there are not sufficient earnings, which is about $21 million, and under the assumption that some earnings would stay with the System. Adding these two together is about $26 million or 1%, which would take the 89% funded ratio to 88%. He added that there is the fact that there is a difference between the assumed rate and what the System actually earned this year, so that when the books are closed at the end of the year, this will be evaluated on a five-year smoothing basis. By adding the first two items with this and holding everything else constant, we are looking at the 84% to 85% range based on the Subcommittee's recommendation. This is an important threshold because the 82% level would trigger the City's payments to the accelerated, full actuarial rate.

Mr. Grissom said that a funding ratio of 84% is probable and could actually be worse due to actuarial losses on investments for the '02 fiscal year.

Mr. Casey said he didn't realize the System had reached such doom and gloom. He said he has seen in writing that the Board has the authority to set up reserves as it deems appropriate. It makes no sense to state we can set up reserves but not be allowed to spend them. This is an implied authority as far as he's concerned. Secondly, it points out that whether or not the System had a bad year the idea of using realized gains as a mechanism for funding this operation and pay bills has been around way too long. It's not good in his opinion. Theoretically, it's possible to have a stellar year and for all of the System's managers to underperform and the System could have a negative realized gain and not be able to pay its bills. This doesn't make sense.

Mr. Grissom said this happened in 1990. The System had a total return of plus 9, but didn't have sufficient earnings to pay the 13th check.

Mr. Casey said money was taken from that reserve then to pay the 13th check.

Mr. Grissom said this came out of the Andrew's lawsuit settlement, which carried with it the authority to spend undistributed surplus earnings on a one-time basis.

Ms. Webster asked Mr. Blum if Hanson Bridgett has opined that the Board doesn't have discretion to use different rates.

Mr. Blum said the short answer is yes.

Ms. Webster asked if the Board could use an 8% actuarial assumption rate and credit the accounts with 6%.

For the Board to do this, Mr. Blum said it would be a major fiduciary decision that would require in-depth evaluation. The consequences to the City, all its members, the retirees and the funding status would have to be reviewed. After reviewing all of these issues, if the Board wished to do this, he would strongly recommend that the Board set a policy as such. Otherwise, the Board and this System would be extremely vulnerable. If the Board sets a long-term interest crediting policy, he believes the Municipal Code gives them the authority to do so.

Mr. Pierce said there was one provision of the Municipal Code that stipulated for at least one account that the crediting must be on the earnings assumption rate.

Mr. Grissom said this is stipulated in 24.0103. He read that the undistributed earnings reserve shall mean the balance remaining in the account to which the earnings to the fund are credited after the annual distribution to the employee and employer reserve accounts in accordance with interest assumption rates established by the Board. With the Board's past practice and prudence, if the Board were to change the crediting rate, it should also change the assumption rate. If the Board changes its assumption rate, it would impact a number of things.

In response to Ms. Webster's question about crediting at different rates, Mr. Blum said in his review of 24.0103 and 24.0105, it appears that historically and through Board policy the Board has read these sections together. If this is a fair statement, then in fact, the interest assumption rate is the rate that should be credited. However, if he reads these two sections separately and word for word, he believes it is appropriate for the Board to go through its fiduciary investigation to determine whether they could credit these accounts at different rates on a long-term basis.

Mr. Pierce said two things came up that surrounded this issue. One had to do with the Board's fiduciary duty. Trying to justify other than the long term earnings assumption rate than these accounts were essentially set up to pay the long-term liabilities of the fund and would require a very clear and sound approach. On the employee contribution reserve account, if the Board were to credit less than the actuarial rate and a long term City employee left City employment, they could be damaged. Secondly, to the extent the reserves are credited at the actuarial assumption rate, it keeps that money inside plan assets, which bolsters the funded ratio of the System. If these reserves are credited at any lower interest rate, it allows earnings to drip down the distribution to pay contingent benefits. The Subcommittee did not believe it would be fiduciarily sound to allow certain contingent benefits to be paid when those assets can be kept inside plan assets and bolster the funding.

Mr. Blum said these types of examples would have to be evaluated by the Board. If the Board agrees to lower its interest rate to provide more money to pay contingent benefits, it would essentially be pulling money out of the System, which would weaken the financial status of the fund.

Ms. Webster asked what the actuarial impact would be to lower the interest rate from 8% to 6% and to credit the employer and employee reserves with 6%.

Independent of the valuation, Mr. Roeder said the biggest impact isn't the interest rate used to credit the reserves, but what buckets of money are being excluded and included in the plan assets.

Ms. Webster asked what would happen if the employer reserve were credited with 6%, which is within plan assets.

Mr. Roeder said if the two reserves are in plan assets and the Board was to transfer money from one reserve in plan assets to another reserve in plan assets, there would be no actuarial impact.

Mr. Pierce asked if there would be a zero actuarial impact if there are not enough earnings to flow past that first crediting to pay for the budget.

Mr. Roeder said he believes so.

Mr. Pierce stated that earnings are plan assets. If the reserves are credited at 8%, they stay in plan assets.

Whether there is $10 million in surplus or $500 million in surplus, Mr. Saathoff said these are considered assets as long as everything stays within the plan assets.

Ms. Webster said the Committee is recommending that the Board continue with the 8%. It is her goal as a fiduciary to the fund and to the plan sponsor not to impact the funding ratio any more than necessary. Therefore, she would recommend crediting less than 8% to the employer, employee and DROP reserve accounts.

Mr. Pierce said it is a Municipal Code requirement that DROP be credited from plan assets and has nothing to do with earnings.

Mr. Grissom said Mr. Pierce is correct. There is nothing in the Municipal Code that would allow the DROP account to be credited at a lower interest rate.

Mr. Blum said there are very specific reserves, not in plan assets, where the interest crediting regardless of the amount, will not affect plan assets either in or out for purposes of the valuation.

Mr. Roeder agreed. Currently the Board is holding $3.7 million outside of plan assets.

Mr. Saathoff said the 13th check is a contingent benefit. By not crediting the reserve accounts, it would keep the money in the fund for purposes of the valuation. By not making that credit, that money would flow to an account and leaves plan assets, which clearly affects the valuation of the System. The same is true with funding the health insurance trust. The money is transferred off book and lowers the assets and funding ratio of the System.

Mr. Roeder agreed with regard to the 13th check.

Mr. Blum recommended reviewing each of the reserves. With regard to DROP, it was reported that these assets are held outside the pooled assets used for valuing the System. This affects the valuation of the system.

System. Interest must be credited to the DROP accounts. What has not been addressed is that both DROP assets and DROP liabilities are taken out of the valuation. When the Board adds interest crediting to the DROP accounts and takes those assets out for purposes of the valuation, it simultaneously takes the additional liabilities out for purposes of the valuation. Therefore, this results in a non-event. The reserves listed on Page 24 of the Gabriel, Roeder Smith report include one reserve that reflects $225 million. However, he understands that this really is a non-reserve. The second reserve is for supplemental payments, including the 13th check. This reserve is now held outside of the assets for purposes of the valuation and no interest is to be credited to that reserve. He also understands that this reserve could be used to pay the 13th check if City Council so approves.

Mr. Pierce said if the City Council directs the Board not to pay the 13th check, then based on the Committee's recommendation to move this reserve inside plan assets, it would increase the funded ratio.

Mr. Blum agreed. The next reserve has to do with health insurance and post retirement health care and equals $20,000. These are held outside of assets for purposes of the valuation and do not affect the funded status ratio and will not be credited with interest. However, because the Municipal Code states specifically that retiree health benefits shall be paid from the 401(h) fund, they will be used to pay that benefit. The next is the DROP reserve, which as stated earlier, is an actuarial non-event. Next is the employee contribution rate increase reserve, which is $12 million. Lastly is the Supplemental COLA reserve, which the Municipal Code requires be used for the Supplemental COLA and is taken off book. The Board could legally credit the DROP accounts at a lower interest rate, but he believes the Board would have a vested rights issue in so doing and could set itself up for a lawsuit.

If there were different interest crediting rates, Ms. Webster asked if different amounts of money would be moved off book.

Mr. Blum said "No."

Ms. Webster said she is talking about distributing it among different accounts.

Ms. Wilkinson said the actuarial report lists seven different accounts to be used for various purposes. Mr. Grissom listed four additional reserves.

Mr. Grissom said the ones he listed are held outside plan assets.

Ms. Wilkinson said she recalled one reserve being created to fund the 115 trust.

Mr. Pierce said it was mentioned, but wasn't specifically set up for that purpose.

Ms. Lexin said she understood that the $100 million that was set aside was to be used to fund the 115 trust

Mr. Pierce said the Board didn't make a decision for actually allocating those funds.
If the accounts were consolidated as in Recommendation #8, Ms. Webster asked if this would prohibit the City Council from transferring money from the employer reserve to fund the 13th check if they voted to do so.

As the plan sponsor, Mr. Grissom said City Council could do this.

Ms. Webster said there is no disadvantage in respect to consolidating all of these small reserves into the employer reserve. This would allow the plan sponsor to use these reserves to confer and pay for new benefits if they so choose.

Mr. Grissom said this is correct, with the exception of the health care reserve.

Ms. Webster said Recommendations #3 and #5 could negatively impact the funded ratio. Therefore, she wouldn't consider either of them.

Mr. Pierce said if the Board chose to credit the DROP account at zero, it would not leave plan assets. If the Board chose to credit it at 8%, $5 million would leave the System.

Mr. Blum said there is a vested benefits issue with this.

Mr. Roeder said this is a legal versus actuarial question. If the DROP reserve were credited with zero and $5.2 million remained in plan assets, the DROP reserve would be $5.2 million less then it would have been. This would result in $5.2 million being excluded from plan assets.

Ms. Wilkinson said if the Board decided not to credit the DROP account, the Board wouldn't be creating that liability.

Since this account must be credited according to the Municipal Code, Mr. Blum said it is not an issue and should be put to rest.

With respect to Recommendation #10, Ms. Webster asked if the Board could unilaterally not roll any new benefits into the Manager's Proposal.

Mr. Blum said the issue with this is that the Manager's Proposal may have been interpreted different than the intent. The Board might need to go back and review the Manager's Proposal and inform the City that this was not the intent of the Proposal. The Board's role is to look at its liabilities and determine what the costs are and set the contribution rates within the context of the Manager's Proposal. It is within the Board's purview to insure the City understands what the Board originally agreed to.

Mr. Vortmann asked if the Board has a responsibility to tell the City what must be paid as sound actuarial crediting.

Mr. Blum replied, "Yes." The Board needs to determine if there is a widening gap and if it can live with that gap.

Mr. Saathoff said under the Manager's Proposal, the City's rate increases were capped at 0.5% per year.

Ms. Webster said it is tough to explain earnings globally. The whole concept of distributing earnings requires the Board to determine what its earnings are. The recommendation the Committee is proposing starts out with $43 million. She questioned how the Board can distribute earnings it doesn't have.

Mr. Pierce said the Board would only spend what is available from earnings. The rest would come from plan assets to fund the other things required under the Municipal Code.

Mr. Vortmann said the employer reserve would be used as a last account and would be considered a balancing account.

Ms. Wilkinson said more money is pouring into the employer reserve than is needed.

The Board's obligation under the Municipal Code is to credit interest. Mr. Blum said there is no connection with the financial reality, but there is a connection between what this Board is required to do. This has caused a significant amount of confusion. The bottom line response is that the Municipal Code was not written for this circumstance and needs to be changed. It is for this reason that the Committee is recommending that the Board get rid of these reserves.

Mr. Grissom said he believes there has come a perception over the years that earnings are cash in pocket, which is not the case. The Board has overlaid a cash basis of earnings distribution on a total return basis of its investment program. The Board needs to change this because it doesn't work.

Ms. Webster said it seems that revenue comes from the investment earnings. If not, she asked where the revenue comes from.

Mr. Blum said in reality, revenue doesn't come from investment earnings. Unfortunately, the Municipal Code wasn't written to deal with this type of situation, which is why the Board is in the position it is in and supports why the Board should follow the Committee's recommendations. He reminded the Board that this is a defined benefits plan and the System needs to make sufficient earnings to pay the benefits.

Ms. Webster said this goes against Section 24.1502.

Mr. Roeder said the code was drafted when fixed income, assets and volatility were very small and under very different times.

Ms. Shipione said the Board should look at its assets and the liabilities that will grow over time. If the plan can grow at 8% and there is a deficit, the money needs to come from somewhere. She said it is time to correct the situation and for the Board to determine whether there is something more that can be done now.

Mr. Pierce stated that the Committee was established first to deal with this year. However, it will also be looking at a long-term solution.

As for the longer term, Mr. Roeder said the Board would be doing an experience investigation this year, which will include a look at the System's actuarial assumptions.

Mr. Grissom said Ms. Shipione is correct that this is a step in the right direction.

If the System remains whole and pays its liabilities, Ms. Shipione asked how much would be needed from the City.

Mr. Roeder said this is calculated each year.

Mr. Vortmann informed Ms. Shipione that the answer to her question is on Page 11 of the actuarial valuation. Additionally, City Council has mandated that the Board to try to explain much of what Ms. Shipione is asking along with how to fix the problem. The Committee hopes to address this by June 2002.

Mr. Pierce said it might take a number of meetings to answer everyone's questions.

Mr. Saathoff suggested holding a Board workshop to further address this. It would be extremely valuable if both Mr. Roeder and Mr. Blum could be present.

Mr. Vortmann clarified that the workshop would only address the immediate issues.

Mr. Pierce agreed.

For the record, Ms. Lexin stated that there are a number of perspectives that have not been discussed.

Ms. Shipione suggested inviting the City to present their concerns and recommendations.

Ms. Lexin said she, Ms Webster and Ms. Vattimo represent the City on this Board.

Staff was directed to schedule a workshop.

Please note: An email was received from the Board's actuary, Rick Roeder after the meeting concluded asking that it be included as a part of the minutes to clarify his comments (Attachment A), with Staff's presentation materials to follow (Attachment B)

XIII. NEXT MEETING: FRIDAY, MAY 17, 2002 – 1:30 PM
RETIREMENT SYSTEM BOARD ROOM
401 "B" STREET, SUITE 400, SAN DIEGO, CA 92101

XIV. ADJOURNMENT – The meeting was adjourned at 5:00 p.m.

Minutes prepared by Board Secretary, Sally Zumalt

Approved by: ______________________
Lawrence B. Grissom, Retirement Administrator

FILE: W:\EXEC\BDSEC\MINUTES\BD\BDM04-19-02

EXHIBIT 13

CONSTANCE M. HIATT
PARTNER
DIRECT DIAL 415 995 5099
REPLY TO SAN FRANCISCO
E-MAIL chiatt@hansonbridgett.com

April 16, 2002

Loraine E. Chapin, Esq.
General Counsel
The City of San Diego
City Employees' Retirement System
401 B Street, Suite 400, MS 840
San Diego, CA 92101-4298

Re: City of San Diego Employees' Retirement System – Surplus Undistributed Earnings

Dear Lori:

Attached is a step-by-step analysis of the consumption of Surplus Undistributed Earnings under the San Diego City Employees Retirement System ("SDCERS"). The Code doesn't provide the ideal authority and guidance for the current economic environment facing SDCERS and the City. This memorandum discusses the relevant San Diego Municipal Code (the "Code") provisions regarding Surplus Undistributed Earnings ("Surplus") and how it may be used, whether contingent benefits may be paid absent Surplus Undistributed Earnings and additional issues and concerns.

Analysis of Code

The Municipal Code defines Surplus Undistributed Earnings as cash earnings received from investments during a year. Essentially, under Section 24.1502, these earnings can be used as follows:

1. Credit interest to employer and employees accounts,

2. To pay the budget for the Retirement System, and

3. To set aside reserves as the Board of Trustees considers appropriate.

If Surplus remains after subtracting the above items, additional benefits are provided in the Code, such as the credit to the Port district, the supplemental 13th check, Corbett settlement payments, and interest to special reserves for supplemental COLAs and employee contribution adjustments.[1]

The main issue presented by the Municipal Code is that the only authorized way many of these contingent benefits can be paid is from Surplus. This presents a problem for the Board in the current economic environment of low or negative earnings. Yet the only authority that the Board has to pay benefits is as defined in the Municipal Code, as discussed below. Below we discuss the application of Section 24.1502.

1) Crediting Interest To The Member And City Accounts

The specific order of benefits that reduce Surplus begins with interest credited to the member and the City accounts.

Section 24.0905 of the Code specifically requires that interest be credited, whether or not SDCERS generates Surplus for the year. The rate of interest is not specified in the Code and Section 24.0905 of the Code clearly grants the Board discretion to set the rate. However, Section 24.0103, defines "Undistributed Earnings Reserve" as the amount remaining in the account to which earnings are credited after the "annual distribution" to employer and employee accounts "in accordance with interest assumption rates established by the Board". Furthermore, we understand that SDCERS has always credited to these accounts the assumption rate that is used in the actuarial valuation. This suggests that SDCERS previously has concluded that Sections 24.0905 and 24.0103 should be read together to determine the interest rate that is credited to the member and City accounts. Therefore, while the Board has the discretion under Section 24.0905 to use some other interest rate, this would be a significant change in its practice. Moreover, a change in the rate of interest credited could have significant effects on Members, Retirees, the City and the overall funding status of SDCERS. In these circumstances, the Board, as fiduciary, would need to fully evaluate a change to the rate of interest as part of its decision in making any change to the interest crediting rate.

2) Cost of Administration

There are two sections that provide funds for payment of the cost of administration. Section 24.1502(a)(2) provides funds from current earnings. However, Section 24.0906 provides for payment from the Undistributed Earnings Reserve.

---

[1] Special, one-time reserves are available for supplemental COLAs and adjustments to employee contribution rates until such reserves are depleted. Retiree health benefits are due whether or not SDCERS has Surplus and the Code establishes a special Fund for retiree health in section 24.1203. Surplus can pre-fund the next year's anticipated retiree health costs.

The Undistributed Earnings Reserve is defined in section 24.0103 and is different from "Investment Earnings Received" in section 24.1501. "Undistributed Earnings Reserve" means the balance remaining in the account to which earnings are credited, after crediting interest to employee and employer accounts in accordance with the interest assumptions rates established by the Board, plus accumulated earnings which have not been so distributed. This language indicates that prior reserves could be used to pay the SDCERS budget because such reserves are accumulated earnings that have not been distributed. This is helpful in the event SDCERS has insufficient current Investment Earnings Received in any one year because the Code permits payment of the budget. The problem is that Section 24.1502(a)(2) also requires that the operating budget, personnel and services costs reduce Surplus Undistributed Earnings, thus leaving less to pay contingent benefits.

3) Appropriate Reserves

Any Surplus remaining after crediting interest and paying the budget can be used to create the appropriate reserves. However, the creation of reserves does not also create the authority to pay benefits. This is a very important aspect of the Code.

The Code clearly specifies the situations where reserves can be used to pay for benefits. This includes the following: the supplemental COLAs provided in Section 24.1504(c) and the employee rate adjustment amounts provided in section 24.1507(a), both of which have dedicated, one-time reserves established under the Code. The Code also specifies that retiree health benefits are paid from the 401(h) Fund, which is a fund dedicated for this purpose under the federal tax laws. Section 24.1203(b)(1) and 24.1204(a).

The Code requires that there must be sufficient remaining Investment Earnings Received before any of the other benefits can be paid[2]. In other words, basic retirement benefits provided under the Code may be paid from reserves but the Code does not authorize payment of the benefits listed in section 1502 except from Investment Earnings Received, with the exceptions of supplemental COLAs, employee contribution adjustments and retiree health.

4) Thirteenth Check

With respect to the supplemental annual benefit of the 13th check, the Code provides that this benefit is available only if there is sufficient Surplus exceeding $100,000. Section 24.1502(a)(7). In the event available Surplus is less than $100,000, no supplemental benefit is payable. The Surplus of less than $100,000 is to be placed in a special reserve until a later year

[2] 2 The Code does not authorize the payment of such benefits out of prior years' earnings or reserves except for a reserve of less than $100,000 discussed below.

when Surplus brings such reserve to more than $100,000, at which time a supplemental benefit is payable. The Code does not authorize any payment of the supplemental benefit except as provided out of annual Surplus (and special reserve for years of Surplus less than $100,000).

5) Corbett Settlement

The payment of the Corbett Settlement benefit is also conditioned on the availability of sufficient Investment Earnings Received. If these are insufficient, then the liability for these benefits is carried forward as a contingent liability that is to be paid when there are sufficient surplus Undistributed Earnings.

6) DROP Interest Credit

Each DROP account must be credited with interest at a rate and manner "determined by the Board". Section 24.1404(c)(5). However, SDCERS has told DROP participants that the interest rate that is credited to their accounts will be the actuarial assumption rate until the Board decides to use a different rate. While the Board clearly can change the rate that is credited, it is unlikely that it can change that rate until it takes clear action to do so, and then most likely only with respect to future periods because of the California "vested rights" rules.

Risks of Litigation

One issue is whether prior practice of paying the contingent benefits creates a litigation risk if certain benefits aren't paid. For example, members may argue that they rely on the 13th check and that the consistent practice of paying the benefit negated any conditions the Code attached to such payments. Clearly such a risk exists and is heightened if the communications to employees regarding these benefits did not consistently establish the contingent nature of the benefit.[3] While this risk may be important in an evaluation by the City of whether the contingency attached to these benefits should be removed, the arguments do not necessarily provide the Board solid ground for making payments absent a sufficient amount of Investment Earnings Received.

The Board may also have questions about what risks are associated with paying benefits not authorized by the Code. Various parties may be interested in challenging such actions. The City has an interest in the finding soundness of SDCERS and could challenge such actions and bring legal action to stop any such payments. Any members who don't receive any unauthorized payments made to others may also be motivated to challenge the payment as a breach of fiduciary duty. Its unclear what remedy would apply if such a challenge were successful, although personal liability of the Board members could be asserted. The remedy could be that

[3] We understand that this benefit previously has been paid only in years of Surplus.

the City has ultimately pay for such benefits through its funding commitment to SDCERS. A less likely challenge is that of the Internal Revenue Service asserting that payments not authorized by the Code were contrary to the plan terms and disqualify the plan.

Issues Presented by the Code

1) Use of Cash Basis to Define Investment Earnings Received

The structure of the Code creates problems for the Board in several areas. The first is the use of a cash basis definition of earnings to define Investment Earnings Received. Cash basis generally is not the method used by SDCERS for recognizing losses, calculating funding needs or evaluating investment returns. Defining Surplus on a cash basis leads to draining off liquid assets and reducing future earning power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long-term earnings assumption, which assumes the earnings in good years will be available to offset losses in negative years. This dampening effect should be taken into account when establishing the assumed rates of return.

2) Funding Determination

Another fiduciary concern is that of the funding determination. The funding determination is used to assess contributions due from the City, if any, under the Manager's Proposal. The actuarial report excludes certain assets form determining the funding level.[4] It also excludes certain benefits from liabilities as "contingent" benefits. Both of these raise issue of fiduciary duties because of the impact on funding of the plan, i.e. its actuarial soundness. The Corbett settlement liability, for example, is excluded from the plan's liabilities because payments are contingent on the existence of Surplus. The benefits, however, carry over from any year without Surplus to the years with Surplus. If one believes SDCERS will earn its assumed actuarial assumption of 8% earnings at any point, one must conclude that while the Corbett liability is deferred, but really isn't contingent except as to time of payment. From an actuarial standpoint, the benefit may be contingent but the Board should be aware and deliberate about considering the impact on funding.

3) Overall Issues for the Board – Evaluating the Reserve Structure

The fundamental issues for the Board include (1) how to remove the fiduciary quandary as a long-term objective and (2) how to protect members' benefits and to improve the Code without undue harm to the City's financial health. Long-term, the Board may want to consider

[4] Page 24 of the recent actuarial report outlines the amounts excluded from assets.

eliminating the reserve concept and including all promised benefits in liabilities and including all assets in the total assets for funding determinations. This would require requesting that the City include all benefits in Code without the contingency of Surplus. To counter any negative effect on funding, the Board may also want to consider evaluating the application of the Manager's Proposal to benefits enacted after the inception of the Manager's Proposal. The Manager's Proposal froze the City's contribution rate for existing benefits for as long as the funding level of SDCERS remained at a certain level (or for a certain number of years). The Board has not requested any increase in the contribution rate even for benefit improvements enacted after the inception of the Manager's Proposal and therefore not covered by the Manager's Proposal.

Please let me know if you have any questions.

Very truly yours,

Constance M. Hiatt

CMH:ajf

cc: Mr. Lawrence B. Grissom

Robert A. Blum

EXHIBIT 14

CLERK'S OFFICE COPY
DO NOT GIVE OUT

(O-82-228)

ORDINANCE NUMBER O- 15758 (New Series)

Adopted on JUN 1 1982

AN ORDINANCE AMENDING CHAPTER II, ARTICLE 4 OF THE SAN DIEGO MUNICIPAL CODE BY AMENDING SECTION 24.0907.1 AND ADDING SECTION 24.0907.2 RELATING TO CITY SPONSORED GROUP HEALTH INSURANCE FOR ELIGIBLE RETIREES.

WHEREAS, The City of San Diego has withdrawn from participation in the Social Security System effective January 1, 1982; and

WHEREAS, the City has declared that certain benefits shall be provided to employees in lieu of Social Security participation; and

WHEREAS, included in the benefits so indicated is a program for City-sponsored group health insurance for eligible retirees of the City as set forth in Resolution No. R-255610, dated January 4, 1982 and Attachment A thereto; and

WHEREAS, it was the intent of the Council to provide such coverage as a permanent benefit for eligible retirees; and

WHEREAS, it was also directed by the City Council that premiums for said City-sponsored group health insurance be paid from and subsequent to July 1, 1982 by the City from the City's share of Surplus Undistributed Earnings; and

WHEREAS, concurrent with such Council direction, the City Attorney was directed to amend the retirement ordinances as necessary to accomplish said objective; NOW, THEREFORE,

BE IT ORDAINED, by the Council of The City of San Diego, as follows:

Section 1. That Chapter II, Article 4, of the San Diego Municipal Code be and the same is hereby amended by amending Section 24.0907.1 to read as follows:

Section 24.0907.1 SURPLUS UNDISTRIBUTED EARNINGS

At the beginning of each fiscal year the Board shall determine the Surplus Undistributed Earnings of the System and shall provide for the distribution of same as follows:

Fifty percent (50%) of such amount shall be credited to the Reserve for Employer Contributions for the sole and exclusive purpose of reducing the System's liabilities except as otherwise provided in Section 24.0907.2 relating to City-sponsored Retiree Group Health Plan payments; fifty percent (50%) shall be credited to an account to provide monies to pay annual supplemental benefits to Qualified Retirees. Sums transferred to the Reserve for Employer Contributions shall be credited to the accounts of the City and its contracting agencies in the same proportion as the employer reserves for their active and retired members bears to the total of all employer reserves for all active and retired members on the preceding June 30. If, at the time of the annual determination, the amount provided for the supplemental benefits is less than $100,000, no supplemental benefits will be paid in that fiscal year and the monies will be placed in a special reserve and be carried forward to ensuing years until such time as the amount to be provided for this benefit from ensuing Surplus Undistributed Earnings and the special reserve is $100,000 or more.

Surplus Undistributed Earnings shall be comprised of investment earnings received for the previous fiscal year, as defined below, less:

(1) an amount sufficient to credit interest to the contribution accounts of the members, City, and the Unified Port District at an interest rate determined by the Board and distributed in accordance with Section 24.0905 and related Board rules;

(2) an amount sufficient to meet the budgeted expenses and costs of operating the System, including all personnel and services for the fiscal year; and

(3) an amount necessary to maintain such reserves for contingencies as the Board deems appropriate on advice of its investment counselor.

Investment earnings received shall include, by way of example but not limited to, all interest received (net of interest purchased) on notes, bonds, mortgages, short-term money market instruments, and savings accounts; cash dividends received on stock investments; and all realized gains and losses from the sale, trade or conversion of any investments. It is the intent of this section that investment earnings for the purpose of distributing annual supplemental benefits to Qualified Retirees shall be determined on a cash basis, except that investment earnings shall be increased or decreased by the amount of the annual amortization of purchase discounts or premiums on interest-bearing investments earned in accordance with generally accepted accounting principles for financial reporting purposes. No subsequent changes in the method of accounting for the System shall affect the determination of investment earnings received. Surplus Undistributed Earnings shall be determined by the City Auditor and Comptroller in accordance with the definitions of this section and shall be certified by the City's independent public accountant.

Section 2. That Chapter II, Article 4, of the San Diego Municipal Code be and the same is hereby amended by adding Section

24.0907.2, entitled "City-Sponsored Group Health Insurance for Eligible Retirees," to read as follows:

Section 24.0907.2 CITY SPONSORED GROUP HEALTH INSURANCE FOR ELIGIBLE RETIREES.

From and after January 8, 1982, The City of San Diego shall provide a City-sponsored Group Health Insurance Program for all eligible retirees. Eligibility for retiree participation in the Program shall be as follows:

(a) The plan shall be limited to:

1. All employees eligible for general membership in the City's Retirement System, or

2. Legislative officers, or

3. Safety members covered by Social Security coverage as of December 31, 1981.

(b) Employee must be on the active payroll of The City of San Diego on or after January 1, 1982, and

(c) Employee must be eligible for and receive a retirement allowance from The City of San Diego, and

(d) Employee must retire on or after January 8, 1982.

Retiree premiums shall be paid by the City from those funds to be credited to the Reserve for Employer Contributions from Surplus Undistributed Earnings as provided in Section

24.0907.1 above. The Auditor and Comptroller shall set aside from such account an amount sufficient to pay premiums as required. Premium rates for eligible retirees shall be determined and established by the City. Health plan coverage for retirees and eligible dependents is subject to modification by the City and the provider of health care services, and may be modified periodically as deemed necessary and appropriate.

Eligible retirees may elect to continue group health insurance coverage for eligible dependents at their own expense. Premium rates for such dependent coverage shall be determined and established by the City.

Section 3. This ordinance shall take effect and be in force on the thirtieth day from and after its passage.

APPROVED: John W. Witt, City Attorney

By Jack Katz
Jack Katz
Chief Deputy City Attorney

JK:smm
:351
5/6/82
O-82-228
Or.Dept:Clerk
Form=r.none

O-15758

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Passed and adopted by the Council of The City of San Diego on JUN 1 1982, by the following vote:

Councilmen	Yeas	Nays	Not Present	Ineligible
Bill Mitchell	☑	☐	☐	☐
Bill Cleator	☑	☐	☐	☐
Susan Golding	☑	☐	☐	☐
Leon L. Williams	☐	☐	☑	☐
Ed Struiksma	☑	☐	☐	☐
Mike Gotch	☑	☐	☐	☐
Dick Murphy	☑	☐	☐	☐
Lucy Killea	☑	☐	☐	☐
Mayor Pete Wilson	☐	☐	☑	☐

AUTHENTICATED BY:

PETE WILSON,
Mayor of The City of San Diego, California.

CHARLES G. ABDELNOUR,
City Clerk of The City of San Diego, California.

(Seal)

By Barbara Berridge, Deputy.

I HEREBY CERTIFY that the foregoing ordinance was not finally passed until twelve calendar days had elapsed between the day of its introduction and the day of its final passage, to wit, on

MAY 17 1982, and on JUN 1 1982.

~~I FURTHER CERTIFY that said ordinance was read in full prior to its final passage.~~

I FURTHER CERTIFY that the reading of said ordinance in full was dispensed with by a vote of not less than a majority of the members elected to the Council, and that there was available for the consideration of each member of the Council and the public prior to the day of its passage a written or printed copy of said ordinance.

CHARLES G. ABDELNOUR,
City Clerk of The City of San Diego, California.

(Seal)

By Barbara Berridge, Deputy.

Office of the City Clerk, San Diego, California

Ordinance Number O-15758 Adopted JUN 1 1982

EXHIBIT 15

CITY OF SAN DIEGO MUNICIPAL CODE / Chapter 2 Government / Article 4: City Employees' Retirement System / Division 15: Investment Earnings, Supplemental Benefits and Adjustments / §24.1502 Surplus Undistributed Earnings

§24.1502 Surplus Undistributed Earnings

(a) Surplus Undistributed Earnings are comprised of Investment Earnings Received for the previous fiscal year, less:

(1) An amount sufficient to credit interest to the contribution accounts of the Members, City and the Unified Port District at an interest rate determined by the Board and distributed in accordance with Section 24.0904 and related Board rules; and

(2) An amount sufficient to meet the budgeted expenses and costs of operating the System including all personnel and services for the fiscal year; and

(3) An amount necessary to maintain such reserves as the Board deems appropriate on advice of its investment counselor and/or Actuary; and

(4) An amount sufficient to credit Unified Port District ("UPD") with a proportional share of Surplus Undistributed Earnings as defined in this Section; and

(5) An amount, (the Division 12 amount), appropriate to provide health benefits to Health Eligible and Non Health Eligible Retirees as provided in Division 12 for the next fiscal year provided:

(A) in the next fiscal year, the City contributes to the 401(h) Fund no less than an equal amount which is designated to be used for retiree health benefits to be paid or reimbursed in the next fiscal year; and,

(B) to the extent the City makes a contribution to the 401(h) Fund for the next fiscal year, the Division 12 amount shall be treated as a portion of normal employer contributions paid to the Retirement System when the City so designates in accordance with Section 24.1203(b)(5); and

(6) An amount sufficient to provide necessary funds to pay an annual supplemental benefit to Qualified Retirees, pursuant to the provisions and conditions set forth in Section 24.1503. If, at the time of the annual determination, the amount provided for the supplemental benefits is less than $100,000, no supplemental benefits will be paid in that fiscal year and the monies will be placed in a special reserve and be carried forward to ensuing years until such time as the amount to be provided for this benefit from ensuing Surplus Undistributed Earnings and the special reserve is$100,000 or more; and

(7) An amount sufficient to increase the Base Retirement Benefit by 7% for all retired City employees and Beneficiaries who are covered by the Corbett Settlement.

(A) The right to receive this increase each year will accrue monthly. But, the increase will be paid annually when the Annual Supplemental Benefit (13th check) is normally distributed. The increase will be paid, on a prorated basis, to the Beneficiary or estate of any retiree who dies during the fiscal year but before the annual payment is made.

(B) To the extent this increase is not paid in any year because there are insufficient Surplus Undistributed Earnings, the liability for this increase will be carried forward as a contingent liability which will be paid in future years in which there are sufficient surplus Undistributed Earnings to pay for the increase.

(C) Liabilities carried forward will be paid in the order in which they accrued.

(8) An amount sufficient to credit interest to the reserves created for Supplemental COLA and Employee Contributions as set forth in this Division.

(b) At the beginning of each fiscal year, the Board will credit all Surplus Undistributed Earnings to the Reserve for Employer Contributions, for the sole and exclusive purpose of reducing Retirement System liability.

(Amended 4-2-2002 by O-19043 N.S.)

EXHIBIT 16

SAN DIEGO CITY
EMPLOYEES' RETIREMENT SYSTEM
ANNUAL ACTUARIAL VALUATION
June 30, 2004

Submitted to
THE RETIREMENT BOARD
San Diego City Employees' Retirement System
San Diego, California

San Diego City Employees' Retirement System
Funding Process Indicators - Historic Comparison

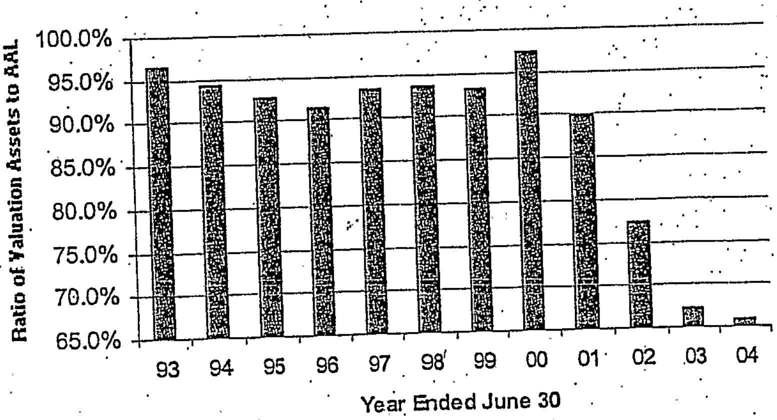
($ in Thousands)

Valuation Date	Valuation Assets	AAL	Funded Ratio	UAAL	Member Payroll	Ratio to Payroll
		Continuation Indicators				
6/30/93	$1,137,019	$1,178,311	96.5%	$41,292	$320,624	12.9%
6/30/94[1]	$1,216,063	$1,290,927	94.2%	$74,864	$338,440	22.1%
6/30/95	$1,316,903	$1,421,150	92.7%	$104,247	$350,584	29.7%
6/30/96[2]	$1,480,772	$1,620,373	91.4%	$139,602	$365,089	38.2%
6/30/97	$1,632,361	$1,748,868	93.3%	$116,507	$382,715	30.4%
6/30/98[1]	$1,852,151	$1,979,668	93.6%	$127,517	$399,035	32.0%
6/30/99	$2,033,153	$2,181,547	93.2%	$148,394	$424,516	35.0%
6/30/00	$2,459,815	$2,343,400	105.0%	($116,414)	$448,502	(26.0)%
6/30/00[3]	$2,459,815	$2,528,774	97.3%	$68,959	$448,502	15.4%
6/30/01	$2,525,645	$2,809,538	89.9%	$283,893	$481,864	58.9%
6/30/02	$2,448,208	$3,168,921	77.3%	$720,713	$535,157	134.7%
6/30/03	$2,375,431	$3,484,832	68.2%	$1,109,401	$533,595	207.9%
6/30/03[4]	$2,375,431	$3,532,626	67.2%	$1,157,194	$533,595	216.9%
6/30/04	$2,628,680	$3,962,237	66.3%	$1,333,557	$540,181	246.9%
6/30/04[5]	$2,628,680	$3,997,328	65.8%	$1,368,648	$540,181	253.4%

AAL - Actuarial Accrued Liability

UAAL - Unfunded Actuarial Accrued Liability

Historic Comparison of Funded Ratio



[1] Reflects revised actuarial and economic assumptions

[2] Reflects Manager's Proposal

[3] Reflects Corbett non-contingent benefit increases

[4] Includes change in benefits for General Members

[5] Reflects revised actuarial assumptions

EXHIBIT 17

INTERIM REPORT NO. 2

REGARDING POSSIBLE ABUSE, ILLEGAL ACTS OR FRAUD BY CITY OF SAN DIEGO OFFICIALS

REPORT OF THE

SAN DIEGO CITY ATTORNEY

MICHAEL J. AGUIRRE

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE: (619) 236-6220

9 FEBRUARY 2005

INTERIM REPORT NO. 2
REGARDING POSSIBLE ABUSE,
ILLEGAL ACTS OR FRAUD BY
CITY OF SAN DIEGO OFFICIALS

REPORT OF THE
SAN DIEGO CITY ATTORNEY
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**1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE: (619) 236-6220**

9 FEBRUARY 2005

Terri [13]

One month later, on 12 February 2002, Terri Webster wrote Auditor Ed Ryan about the full gravity of the financial disaster enveloping the pension plan. As documented in the most recent actuarial report, there was a swing of $486 million against the City:

> Per Larry the actuary report shows a $200M loss....that's a $486m swing from the last report. Funding ratio drops to 90% from 97%...this assumes the $100m set aside for meet and confer is in assets. The trigger point is 82%. ...
>
> Ugly Ugly [emphasis added]
> They project a $60m shortfall for FY 02 earnings.[14]

On 12 February 2002, the actuarial report that Ms. Webster referred to in her email to Mr. Ed Ryan was released to pension board members. It showed that the funded ratio of assets to liabilities had dropped to 89.9% and that the unfunded actuarial accrued liability had grown from $68,959,000 to $283,893,000, a 290% increase.[15] On 28 February 2002, in light of the further slide of the funding ratio,

---

[13] 3 January 2002 emails between Cathy Lexin and Terri Webster. (Exhibit 10)

[14] 12 February 2002 Email from Terri Webster to Ed Ryan on the subject of EGF and CERS. (Exhibit 11)

[15] San Diego City Employees' Retirement System Annual Actuarial Valuation 30 June 2001 p. 13. (Exhibit 12)

auditors Ed Ryan and Terri Webster had a discussion with City officials involved in the employment negotiations with the unions representing City workers. The topic of this discussion was the need to include the effect of the trigger on the meet and confer labor negotiations.

> 2/289/2002 8:10 AM
> Email from Mary Vattimo to Ed Ryan, Terri Webster and Cathy Lexin
> (cc to Bruce Herring)
> Re: CERS earnings
>
> I think that discussing with Ron is good advice; he has indicated he doesn't understand what the big deal is.
> Mary
>
> >>>Ed Ryan 02/28/2002 7:54:16 am>>>
> Cathy, Bruce You might want to use Ron Saathoff to get their attention. I don't believe you can conclude meet and confer without knowing what retirement is going to do. That means they have to tell the City likely by the <u>March meeting</u>. [emphasis added] I believe the Manager has to tell Council the budget status before meet and confer concludes and he'd have to know the retirement solution to do that.
>
> >>>Terri Webster 02/27/02 04:40 PM>>>
> OH BOY….the CERS earnings for Jan is negative ($1.7)…we're moving in the wrong direction! So thru Jan 02 we're at $25 million compared to $146m last year almost 6 times worse than last year…
>
> I spoke to Fred and still don't think he gets the point that we need answers now…and not just for a $60m shortfall but scenarios to cover a $70m and $80m shortfall.
>
> Remember the FY 01 funding ratio dropped significantly when earnings were $165M. So at $40-60m it will be ugly.

Terri [16]

During this period auditor Webster explained in detail to a member of the pension board why the earning losses created a "fiscal time bomb" for the City:

> I think your questions centered around why does the City care about the solution to the FY 02 earnings problem?
>
> **1. Funding Ratio:** <u>Fiscal time bomb</u> is attached to this. [emphasis added] If it drops below 82.3% the City has to pay an additional/approx $26m a year.
>
> Solutions that do not impact the funding ratio are the best. We need to know what the impact to the ratio is for the earnings solution...as well as I asked for the projected ratio based on FY 02 earnings.
>
> The funding ratio is dropping rapidly in the present and last 2 year's investment market. If it dropped from 97.3% to 89.9% in one year and FY 02 are 1/5 of the FY 01 earnings....then it is likely to drop real close to the 82.3% trigger. Therefore anything that negatively impacts the ratio needs to be known ASAP.
>
> **2. Rating Agency impacts:**
>
> The Funding Ratio is a fiscal indicator of the health of the CERS fund which is a major fund of the City. A large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating. The City has a high credit rating which is vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc.

---

16 28 February 2002 (8:10 AM) Email from Mary Vattimo to Ed Ryan, Terri Webster, Cathy Lexin, copied to Bruce Herring on the subject of CERS earnings.

3. Plan for more declines and Preserve every basis point of the ratio: this is essential now since the impact of the bad market is far from over....the actuary lags a year...so we probably have at least 2 very more lean years ahead.
Don't use assets unless absolutely have to.

4. Meet and Confer: is going on now...answers are needed from retirement now as compensation offers are being exchanged and the Mayor, Council and City Manager need to know what the current and projected CERS status is as they consider possible retirement enhancements.
Terri[17]

On 6 March 2002 and 7 March 2002, Ms. Webster and plan administrator Larry Grissom were exchanging the latest information on the erosion of the pension plan earnings and discussing whether the plan would reach the balloon payment trigger:

Lawrence Grissom 03/06/02 5:32PM

Hi Terri

*** Preliminary recommendation from staff (lucky me) is that ---- earnings still look to be in the $50 to $60 million range. ***
***
New benefits are a question mark. We are so close to the line on funding ratio, that Rick [Roeder] or I cannot predict until labor relations gives us something specific. If they go the general member increase and increase the offset, my best guess is that with a flat investment environment ie no gains, no losses, we will be around 83%.

---

17 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

Gonna get ugly [emphasis added]

Larry
CC: Cathy Lexin; Ed Ryan[18]

On 15 April 2002, the magnitude of the pension plan's staggering losses became clear to Assistant Auditor Webster and pension administrator Grissom:

Lawrence Grissom 04/15/02 3:24PM
Terri
Please treat this as confidential for the moment.....haven't shared with any of the other Board members—yet.
***
* I hope I'm wrong, but projections of the value of assets lead me to believe that actuarial losses on investments could be nearly twice as much this year over last year. That could be a reduction in the funding ratio of 7%, if all else is equal. Those two things, without any other actuarial losses or additions to liabilities for new benefits, etc. put us at about 80%. Not a happy situation [emphasis added]

***
Like I said, don't shoot the messenger.[19]

Ms. Webster responded to Grissom, reminding him that the funding ratio was really 89% not 89.9%:

From: Terri Webster
To: Lawrence Grissom
Date: 4/15/02 5:58 PM

---

18 6 March 2002 (5:32PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 14)

19 15 April 2002 (3:24 PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 15)

Subject: Re: Don't shoot the messenger — !!

***also awaiting actuary answers like how exactly calculate the $95.6 loss...also I think the 89.9% in [sic] around 89% since it appears the actuary counted all of the 105M reserve as since versus just the 100M....[20]

The avalanche of negative financial reports overwhelmed pension board and City officials. On 26 April 2002, auditor Webster admonished Human Resources Coordinator Cathy Lexin not to discuss the funded ratio until they both could get their stories straight:

From: Terri Webster
To: Cathy Lexin
Subject: funding ratio
Cathy

I recall you mentioning that Larry said we'll be at a 84-86% funding ratio at 6-30-02. That makes no sense! I recommend not mentioning that especially on Monday since we're getting different stories. I have an email from Larry, less than two weeks ago which projected it to be at 85% on 6-30-02...the big drop (7%?) Will be due to FY 02 poor investment growth as well as a 1-2% loss due to the FY02 earnings solution.....so it makes no sense to me to now hear 84%. (Also we're at 89% no 89.9% since the actuary mistakenly gave us credit for $5.8 million of port money.) [emphasis added] [21]

---

[20] 15 April 2002 (5:58 PM) Email from Terri Webster to Lawrence Grissom. (Exhibit 15)

[21] 26 April 2002 Email from Terri Webster to Cathy Lexin about the subject of "funding ratio." (Exhibit 16)

B. CITY STAFF FIGHTS OVER THEIR OWN BENEFITS

By 17 May 2002, pension and City officials were fighting among themselves over their own benefits. The issue that sparked the internal bickering revolved around the lifting of the 90% cap for certain employees including Assistant Auditor Webster:

> Terri Webster 5/17 5:25 PM
> Why is this still out there? The maker of the "deal" Cathy/Dan, clearly clarified that DRAFT language is not binding and if there is a better way to do implement a 90% cap and the 2.5 at 55 that meets the City, union, members, and CERS needs...then Fine, we're not stuck with the old language.
> I thought we were now all working on the same project of fine tuning that solution...hence "Paul and Holly's" versions that just need some tweaking on Monday...we're almost there....
> Again...<u>why is Cathy's intent still being questioned</u> and desires to move backwards are expressed? [emphasis added]
> Terri[22]

Three days later, on 20 May 2002, Mr. Grissom lashed out at Ms. Webster and other City officials for "further attempting to 'pad'" their own benefits:

> Terri
> ***
> If, after being accused of violating everything and further <u>attempting to 'pad' your own benefits</u>, you guys feel you get another bite at the apple, go for it. I did not read Cathy as being at all amenable to changing the basic concept. If she did, then great! I honestly don't care how we do it, so long as everyone is on the same page. No

---

[22] 17 May 2002 (5:25 PM) from Terri Webster to Lawrence Webster on the subject of the "deal." (Exhibit 17)

desire to move backward on my part. You can't move backward until you've gotten somewhere in the first place. [emphasis added]
Larry[23]

Auditor Webster shot back at Grissom, defending herself and arguing that she did not get any "better benefit" and that the "statement 'pad your own benefits' is wrong."

5/20/2002 (10:26 AM)
From: Terri Webster
To: Lawrence Grissom
Subject: Re: Curmudgeon speaks

For the record, to my knowledge, the people working on this like myself, Holly, Bob, Dan, Paul .... get no better benefit under "Paul's or Holly's" version that [sic] the original draft/your write up ..... so the statement "pad your own benefits" is wrong.

We're looking at what is fair and reasonable and thinking of the General Members as a whole versus individually. If their [sic] is a specific "hole" or "risk" in the theory that you see as the Retirement Administrator, please let Cathy/Dan/all know immediately because at this point no one has stated any problems with 'Paul's/Holly's' proposed solution in terms of "detriment/harm/risk" to the system, the City, or the members.
Terri[24]

23 20 May 2002 (10:03 AM) Email from Lawrence Grissom to Terri Webster. (Exhibit 17)

24 20 May 2002 (10:26 AM) Email from Terri Webster to Lawrence Grissom regarding "Curmudgeon speaks." (Exhibit 17)

C. DISCUSSION SHIFTS TO GRANTING BENEFITS IN EXCHANGE FOR WAIVING THE TRIGGER

When City officials learned of the impending trigger and multi-million dollar balloon payments, they developed a plan to negate the trigger and avoid the payments. To induce the pension board to take these actions, the City extended new benefits to both City workers and to three union presidents. Thus City officials intended to increase benefits even though the pension plan was unable to pay for hundreds of millions of dollars in benefits already granted.

Emails confirm that pension board members violated their fiduciary duties to protect fund assets in exchange for new benefits that they received.[25] On 21 May 2002, City Auditor Webster sent an email to labor negotiator Dan Kelly, Auditor Ed Ryan, and other City officials seeking reassurance that Fire Fighter Union President Ron Saathoff would prevail on the pension board to waive the trigger and forgive the balloon payment. Mr. Saathoff was to receive a substantial presidential benefit in exchange for his help:

> Dan
> The local 145 write up you sent out did not state that their increased offset was contingent on the Board laxing the trigger.....I thought ALL retirement improvements (<u>including the presidetial [sic]</u>

---

[25] See, San Diego City Charter Article IX § 143; Cal State Constitution Article 16 § 17 (retirement board of public pension plan has "fiduciary responsibility for ... administration of the system.") (Exhibit 18)

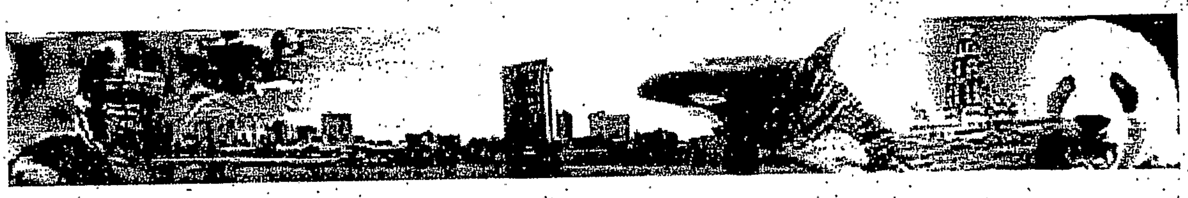
EXHIBIT 18

SAN DIEGO CITY

EMPLOYEES' RETIREMENT SYSTEM

ANNUAL ACTUARIAL VALUATION

June 30, 2004



Submitted to

THE RETIREMENT BOARD

San Diego City Employees' Retirement System

San Diego, California

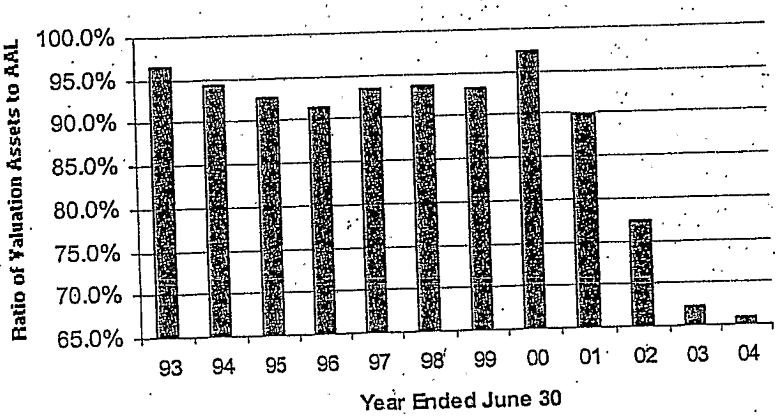
San Diego City Employees' Retirement System
Funding Process Indicators - Historic Comparison

($ in Thousands)

Valuation Date	Valuation Assets	Continuation Indicators				
		AAL	Funded Ratio	UAAL	Member Payroll	Ratio to Payroll
6/30/93	$1,137,019	$1,178,311	96.5%	$41,292	$320,624	12.9%
6/30/94[1]	$1,216,063	$1,290,927	94.2%	$74,864	$338,440	22.1%
6/30/95	$1,316,903	$1,421,150	92.7%	$104,247	$350,584	29.7%
6/30/96[2]	$1,480,772	$1,620,373	91.4%	$139,602	$365,089	38.2%
6/30/97	$1,632,361	$1,748,868	93.3%	$116,507	$382,715	30.4%
6/30/98[1]	$1,852,151	$1,979,668	93.6%	$127,517	$399,035	32.0%
6/30/99	$2,033,153	$2,181,547	93.2%	$148,394	$424,516	35.0%
6/30/00	$2,459,815	$2,343,400	105.0%	($116,414)	$448,502	(26.0)%
6/30/00[3]	$2,459,815	$2,528,774	97.3%	$68,959	$448,502	15.4%
6/30/01	$2,525,645	$2,809,538	89.9%	$283,893	$481,864	58.9%
6/30/02	$2,448,208	$3,168,921	77.3%	$720,713	$535,157	134.7%
6/30/03	$2,375,431	$3,484,832	68.2%	$1,109,401	$533,595	207.9%
6/30/03[4]	$2,375,431	$3,532,626	67.2%	$1,157,194	$533,595	216.9%
6/30/04	$2,628,680	$3,962,237	66.3%	$1,333,557	$540,181	246.9%
6/30/04[5]	$2,628,680	$3,997,328	65.8%	$1,368,648	$540,181	253.4%

AAL - Actuarial Accrued Liability
UAAL - Unfunded Actuarial Accrued Liability

Historic Comparison of Funded Ratio



[1] Reflects revised actuarial and economic assumptions
[2] Reflects Manager's Proposal
[3] Reflects Corbett non-contingent benefit increases
[4] Includes change in benefits for General Members
[5] Reflects revised actuarial assumptions

EXHIBIT 19

REPORT ON INVESTIGATION

The City of San Diego, California's

Disclosures of Obligation to Fund the

San Diego City Employee's Retirement System

and Related Disclosure Practices

1996-2004

with

Recommended Procedures and Changes to the Municipal Code

September 16, 2004

Paul S. Maco
Richard C. Sauer
Vinson & Elkins L.L.P.
Washington, D.C.

that time, explained in an interview with Vinson & Elkins attorneys that the change in method was intended to reduce City contributions to SDCERS at a time of intense pressure on the City's General Fund. SDCERS administrators have confirmed that there was no purpose for the switch in methods other than to provide temporary contribution relief to the City.

It was anticipated by the SDCERS staff and actuary that the PUC rate would eventually increase to the point that it equaled the EAN rate, at which time the City would resume making contributions at the EAN rate. This apparently never happened.[130] Although the gap narrowed significantly in the mid-1990s, the PUC rate, as applied to the City's contributions to SDCERS, has remained more volatile than the EAN rate without ever exceeding it. As described below, however, conversion back to the EAN method remains a stated goal of the City.

In addition, as of June 30, 1991, the City reset the period for the amortization of its UAAL. The amortization period remained 30 years, but was restarted from that fiscal year-end. The result was to stretch out the period for the amortization of the UAAL, thus reducing that component of the ARC. Again, there appears to have been no purpose for this action other than to reduce the City's contributions to SDCERS.

The System's actuary acceded to actions of this type, so long as they remained within the sometimes-vague standards that govern actuarial science. This remained the case in later years as the City struggled to restrict the impact on its General Fund of escalating liabilities to the retirement system. In 1998, for example, at the suggestion of SDCERS actuary Gabriel Roeder Smith & Company, the City adopted a 40-year amortization period, for purposes of *expensing* (and consequently reporting) its UAAL, in contrast to the 30-year amortization period used for calculating its annual contributions to SDCERS. As described below, this treatment has allowed the City to report a lower "net pension obligation" ("NPO") every year from FY 1997 forward, and was not clearly disclosed by the City until January 2004.

Although migrating to the PUC funding method and resetting the amortization period did not violate established actuarial standards, these actions eventually made a contribution to the under-funding of SDCERS. Then, as now, California law recognizes the minimization of employer contributions as a legitimate objective for pension system fiduciaries.[131] This objective, however, is clearly subordinate to their responsibility to protect the actuarial soundness of the systems they serve.[132]

---

130 For many years no calculation was made of what the contribution rates would have been under the EAN method. But for the last three years, the SDCERS actuary has calculated the City's ARC under both the PUC and the EAN methods and, in each case, the PUC rate resulted in a significantly lower contribution.

131 Cal. Const. art. XVI, § 17.

132 *Sacramento v. Public Employees Retirement System*, 229 Cal. App. 3d 1470, 1493-94 (1991).

EXHIBIT 20

SETTLEMENT AGREEMENT AND RELEASE

This Settlement Agreement and General Release (the "Agreement") resolves and terminates the following lawsuits:

(i) *Gleason v. San Diego City Employees' Retirement System, et. al.*, San Diego County Superior Court Case No. GIC 803779 ("*Gleason*"), a class action lawsuit;

(ii) *Gleason v. San Diego City Employees' Retirement System*, San Diego County Superior Court Case No. GIC 810837 ("*Gleason II*"); and

(iii) *Wiseman v. Board of Administration of the San Diego City Employees' Retirement System*, San Diego County Superior Court Case No. GIC 811756 ("*Wiseman*"). The *Gleason, Gleason II,* and *Wiseman* lawsuits will collectively be referred to herein as the "Actions."

The parties to this Agreement are:

1. James F. Gleason and David W. Wood, individually and on behalf of all persons who are no longer employed by the City of San Diego and are entitled to receive benefits from the San Diego City Employees' Retirement System. Collectively, the plaintiffs in the *Gleason* class action may be referred to as the "Class Plaintiffs."

2. James F. Gleason, individually.

3. Rosado Wiseman, individually.

4. The San Diego City Employees' Retirement System and the Board of Administration of the San Diego City Employees' Retirement System("SDCERS").

5. The City of San Diego together with its employees, representatives, attorneys, agents, Council members, and elected and appointed officials (collectively, the "City".)

6. Pursuant to this Agreement, the "Settlement Class" shall be defined as: "All persons who, as of April 6, 2004, were no longer employed by the City and are entitled to receive benefits from SDCERS, and their spouses, children, heirs, successors and assigns."

2. **NON OPT OUT CLASS AND NOTICE OF SETTLEMENT.**

a. Because the form of relief being provided by this settlement is in the nature of primary equitable relief for alleged actions that are generally applicable to the entire Settlement Class, the parties have agreed to settle in the manner of a "Federal Rule 23(b)(2)" settlement, which does not require that members of the Settlement Class receive notice of the class certification and the opportunity to opt out of the Settlement Class. This provision is an integral component of this Settlement.

b. After the Court tentatively approves this Settlement, SDCERS shall mail notice of the proposed Settlement to the Settlement Class, notifying members of the Settlement Class of their right to object to the settlement (the "Class Settlement Notice").

3. **SETTLEMENT CONSIDERATION.**

In consideration of the release set forth below in Section 4 and the other promises made herein, the Parties agree as follows:

a. <u>The City's Annual Contributions For Fiscal Years 2006 through 2008, and Security for Performance of Charter Obligations</u>

Under the provisions of Article IX, Section 143 of the City Charter of the City of San Diego (the "Charter"), the City is obligated to contribute for fiscal years 2006 through 2008 to SDCERS an amount derived from the rates calculated by the actuary for SDCERS in its annual valuation and approved by the SDCERS Board of Administration (the "Contribution Amount"). The City acknowledges its Charter obligation to pay the Contribution Amount for fiscal years 2006 through 2008. Such obligations are expressly limited to future fiscal years 2006 and beyond, and do not in any way create a Charter obligation to pay any amount greater than the City has already contributed to SDCERS for any fiscal year prior to 2006. Payment of the Contribution Amounts described below are in full satisfaction of the City's Charter obligations for each fiscal year.

In addition to the terms set forth below, the City agrees to provide collateral to secure payment of the annual contribution obligation through FiscalYear 2008.

Commencing with the June 30, 2004 Annual Actuarial Valuation, the amortization period for the Unfunded Actuarial Accrued Liability ("UAAL") will be reset to a new 29-year fixed amortization period. The City's Contribution Amount for Fiscal Years 2006, 2007 and 2008 only (the "Period"), will be based on the 29-year fixed amortization period reset as of the June 30, 2004 Annual Actuarial Valuation (i.e., the FY 06 Contribution Amount will be calculated based on year 29 of a 30 year fixed amortization period, the FY 07 Contribution Amount will be calculated based on year 28 of a 30 year fixed amortization period, and the FY 08 Contribution Amount will be calculated based on year 27 of a 30 year fixed amortization period). After Fiscal Year 2008, subject to any amendment to the Charter, the City will remain obligated pursuant to the Charter to contribute to SDCERS an amount derived from the rates calculated by the SDCERS actuary in its annual valuation and approved by the SDCERS Board of Administration, and SDCERS may utilize any amortization schedule it chooses, consistent with Article XVI, section 17, of the California Constitution and may implement any new, different, or modified actuarial assumptions, and /or funding methods, in consultation with its actuary, for purposes of establishing the City's annual employer contribution thereafter. The parties acknowledge that amortization schedules selected by SDCERS after Fiscal Year 2008 may be considerably shorter than 30 years, in which event there will be a substantial increase in the City's contribution amount. In calculating the contribution rates for the Period, the actuary will use the assumptions and PUC funding method included in the experience evaluation adopted by the SDCERS Board at its February 2003 meeting.

For the purposes of this Agreement only, the Contribution Amount shall be exclusive of the payments of employee contributions paid by the City, if any, employer contributions to DROP, and any other additional contributions paid by the City on behalf of its employees.

It is the parties' intent to herewith provide for certain collateral to secure performance of the City's Contribution Amount through SDCERS' Fiscal Year 2008. The collateral will consist of real property owned by the City unencumbered (except by leases, easements or deed restrictions) and having fair market value (using the methods described in this paragraph) of at

EXHIBIT 21

FINAL REPORT

CITY OF SAN DIEGO PENSION REFORM COMMITTEE

SEPTEMBER 15, 2004

THE CURRENT FUNDED STATUS OF THE SYSTEM

- The most recent formal Actuarial Valuation of the Plan is as of June 30, 2003. In that valuation, the Unfunded Accrued Actuarial Liability (UAAL) was calculated at $1.157 Billion and the Plan was determined to be 67.2% funded.

- At June 30, 2003, the Fair Market Value (FMV) of Plan assets was $2.329 Billion, while the Actuarial Value was $2.375 Billion. The difference of $46 Million will be recognized over future periods. ***Note: Adjusted to exclude Port and Airport Assets.***

- The annual valuation does not consider the present value of the Plan's contingent benefits. Contingent benefits are primarily Corbett settlement, 13th check, COLA etc.

- The UAAL was updated to January 31, 2004. Rather than $1.157 Billion as was identified at June 30, 2003, the UAAL had increased to $1.167 Billion. The funded ratio, however, had increased slightly to 68.7%.

The Committee calculated the amount of contribution that would need to be transferred into the Plan during FY05 to keep the UAAL from growing as follows:

Contribution Components	(in millions) **Contribution Amounts**
Normal Cost	$76.01
Contingent Benefits	20. 30
Retiree Medical Benefits (current year premium only)	13.00
Interest (foregone earnings) on the UAAL	93.36
Total	$202.67*

(*Excludes the unfunded liability for medical costs)

EXHIBIT 22

FINAL REPORT

CITY OF SAN DIEGO PENSION REFORM COMMITTEE

SEPTEMBER 15, 2004

In FY04, the City's contribution to the Plan was $85 Million. The agreed-upon payment for the lawsuit in FY05 is $130 Million, ramping up to approximately $180 Million in FY08.

RETIREE HEALTH CARE

THE SECOND DEFICIT IN SDCERS RELATES TO RETIREE HEALTH CARE.

Current retirees' health care is being paid from a special reserve within the Pension Plan.

Currently, this is a "pay as you go" system. Based upon a 5% annual "Medflation" rate, the liability is estimated at $545 million.

	(in millions)
Normal Cost	$26.08
Amortization of Liability	$58.96
TOTAL	**$85.04**

EXHIBIT 23

21460.1

GSRS

GABRIEL, ROEDER, SMITH & COMPANY
Consultants & Actuaries

9171 Towne Centre Drive • Suite 440 • San Diego, California 92122 • 858-535-1300 • FAX 858-535-1415

November 5, 2002

Board of Retirement
Mr. Larry Grissom
Retirement Administrator
San Diego City Employees' Retirement System
401 B Street, Suite 400
San Diego, CA 92101-4227

Re: Agreement Regarding Employer Contributions Between the City and SDCERS

Dear Members of the Board and Larry:

We are making the following statements in regard to the amendment to the Manager's Proposal.

a) The Agreement, which includes all of the points set out in paragraph 8 above, provides for better funding of SDCERS than does the existing Manager's Proposal, if the 82.3% funding ratio trigger point is not hit,

b) If the 82.3% funding ratio trigger point is hit, then under two of the three interpretations of the current Manager's Proposal higher contributions would be received from the City.

c) It is likely that the 82.3% trigger point will be hit by June 30, 2003, because of the way that SDCERS' assets are valued for the actuarial valuation.

d) The higher the City's contributions levels, the better for the funding status of SDCERS.

e) The current drop in the market asset values has contributed substantially to the drop in SDCERS' funding ratio. This drop cannot be made up in full in any short period by an actuarially determined increase in the City's contribution rates, but steady contribution increases would be best.

f) The sooner that the City's contribution rate is at the full PUC rate the better. The sooner that the City's contributions rate is at the full EAN rate the better.

g) From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger (particularly if one of the two "high contribution rate" interpretations of the effects of hitting that trigger were to prevail).

h) From a pure actuarial viewpoint, we would prefer it if the Board did not provide a transition period to the City to reach the full PUC rate and then move to the full EAN rate.

i) The Board must exercise its judgment in deciding whether a transition period is needed to ramp up contributions to the PUC and/or s EAN rates.

j) If the Board decides that a transition period is needed, then the transition period chosen is reasonable as the City will commit to contribute an additional amount each year starting in July 2004; if the 82.3% accelerated funding trigger is hit the ramp up to full PUC rates will be accelerated; the City will contribute the full PUC rate starting in July 2008; the entire agreement will sunset on June 30, 2010; and the City and Board agree to move to the EAN rate rapidly after that date.

Very truly yours,

Rick Roeder

Rick A. Roeder, EA, FSA, MAAA

CC: Connie Hiatt, Esq.
Robert Blum, Esq.

REPORT ON INVESTIGATION

The City of San Diego, California's

Disclosures of Obligation to Fund the

San Diego City Employee's Retirement System

and Related Disclosure Practices

1996-2004

with

Recommended Procedures and Changes to the Municipal Code

September 16, 2004

Paul S. Maco
Richard C. Sauer
Vinson & Elkins L.L.P.
Washington, D.C.

MP1 lowering the trigger provision from 82.3% to 75%. On June 10, 2002, he submitted a written proposal requesting that modification to MP1, as well as the Board's agreement that, should the funded ratio decline below the new floor, the City would have a five-year period to ramp up to the full PUC rate.[259] His expressed reasons for this request included the terrorist attack of September 11, 2001, the collapse of the dot.com economy, raids by the State of California on San Diego revenues, and the benefit enhancements mandated by the *Corbett* settlement. He stated that the cost of the benefit enhancements coming out of the meet and confer process, estimated at 1.52% of payroll, would be incorporated in the City's contribution levels, which would otherwise continue to follow the schedule provided by MP1.

B. SDCERS' fiduciary counsel and actuary recommend against the first iteration of MP2

The SDCERS Board sought advice from its fiduciary counsel and actuary, and it quickly became apparent that neither would approve the proposal without significant modification. Fiduciary counsel Constance Hiatt and Robert Blum of Hanson Bridgett, in a June 12, 2002 draft letter to SDCERS, described the new Manager's proposal as, in essence, a request that the retirement system give up something of value – the protection of the 82.3% floor – in exchange for nothing. Unlike previous fiduciary counsel, they did not consider the contingent benefit enhancements as an adequate *quid pro quo* in determining whether the SDCERS Board had been offered an acceptable bargain on behalf of System membership. Rather, they focused exclusively on the effect the proposal would have on the financial soundness of the System.

They began their draft opinion letter by noting that the City had been contributing to SDCERS at a level below the actuarial rate since July 1, 1997, and that the disparity between the actuarial rate and the paid rate was increasing. For FY 2003, the City's contributions, pursuant to the first Manager's proposal would be 10.44%, a full 5.26% below the actuarial rate of 15.59%. To date, MP1 had cost SDCERS $90 million in foregone City contributions, including interest. Further, they noted that the anticipated funded ratio at June 30, 2002 was approximately 82.3% – the trigger level for MP1.[260] This would represent a decline of approximately 7.6% over the current valuation.

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259 Memorandum from Michael T. Uberuaga, City Manager, to San Diego City Employees' Retirement System Board of Administration, Subject: Proposal of the City of San Diego Regarding Employer Contribution Rates, Health Insurance and Reserves, at 2 (June 10, 2002). The exact language of this proposed provision was:

> If the actuarial rate falls below the floor in any year, the City will increase its contribution rate on July 1 of the following year by an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent four years in order to achieve the full actuarial rate over a five year period.

260 The actuarial valuation would not be completed for many months and would then conclude that the funded ratio at June 30, 2002 was 77.3%. Neither this nor the 82.3% projection in counsel's letter included the additional cost of approximately 2.5% of payroll that would result from factoring in the contingent element of the *Corbett* settlement.

Ms. Hiatt and Mr. Blum interpreted the trigger mechanism, in accordance with its actual wording, to require that the City make a one-time payment to restore the funded level to the specified floor. Offering the example of a decline in the funded ratio to 80.0%, they estimated that this would require a contribution of approximately $75 million above the scheduled amount. Their letter notes that the new Manager's proposal would allow the City to escape its obligation to make such a balloon payment. Counsel viewed this as a sign that MP1 had proven unworkable. At the time MP1 was under consideration, the City had represented that it would address any potential balloon payment situation by increasing its payments to the System. But, in the event, the City had failed to do so, instead citing financial hardship and requesting additional leniency from SDCERS. In counsel's view, this signaled deterioration in San Diego's financial situation that should be of concern to the Board.

More generally, counsel addressed the proposal as a request by a borrower (the City) for a credit accommodation from its creditor (SDCERS), and found little to recommend it from the creditor's standpoint. "Viewing the City as a 'borrower,' as the Board did in 1996, the City is requesting more favorable terms even though its 'debt' is greater than in 1996 and the original deal objective was not reached."[261] Counsel found that the proposal would weaken the protection to the System provided by the trigger mechanism – which the letter notes was of particular significance to the System's actuary in approving MP1 – without providing any mitigating benefits.[262]

The Hanson Bridgett letter rejects the argument that additional benefits could, in and of themselves, constitute an acceptable *quid pro quo* for the additional "flexibility" in scheduled contributions requested by the City. Although "the courts have indicated that the impairment of the vested right to a soundly funded retirement system can be mitigated by providing comparable new benefits," Counsel concluded that this doctrine goes only to the employer's contractual obligations and not the Board's fiduciary duty to act in a "prudent" fashion. Raising obliquely the perverse incentive created by the benefits-for-contribution-relief aspect of MP1, Ms. Hiatt and Mr. Blum pointed out that, if this were a permissible approach:

> each time [an employer] persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. This would not pass elementary actuarial requirements. Instead, as set out in the Municipal Code, whenever benefits are increased they should be paid for in accordance with the standard actuarial practice,

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261 Draft letter from Constance M. Hiatt and Robert Blum, Hanson Bridgett, to Lawrence Grissom, SDCERS, at 7 (June 12, 2002).

262 Hanson Bridgett appears to have derived little comfort in the trigger mechanism as a safeguard against under-funding. The letter notes that the floor level is most likely to be hit during periods of economic downturn, when the City will be least able to make additional contributions. Its letter also points out that the 75% level proposed by the Manager's Office is substantially below that used by ERISA "to determine when the employer must make additional contributions to certain private sector plans." *Id.*

> so normal cost is paid currently and past service costs amortized over an appropriate number of years...[263]

In considering what *would* justify the requested rate relief, counsel suggested: "the Board may wish to consider a lower 'trigger' point if there were material increases in the City's scheduled contributions, so the funding level of SDCERS is substantially strengthened on a current basis." Fiduciary counsel also urged that the Board ensure that all benefit increases (past, present and future) be reflected in the City's contribution rate. This was stated to be necessary to bring the City into compliance with Section 24.0801 of the Municipal Code, which required that it contribute an amount to SDCERS that covered the normal cost of the System, plus the amortization of past service liabilities over no more than 30 years.[264]

The letter concluded that, should the Board approve the proposal in its current form, a court might conclude that: "the decision was not a proper exercise of the Board's fiduciary responsibilities based on the facts before the Board and the actuaries [sic] opinion to the contrary." The daunting list of remedies a court could then impose included:

> ordering the Board to reconsider its decision; ordering members of the Board who were directly involved in the bargaining process to recuse themselves from any reconsidered decision; ordering the permanent removal from the Board of some or all of its members... [and] imposing personal liability on each member of the Board who voted to approve the proposed amendment...[265]

The SDCERS actuary, Mr. Roeder, was, if possible, less favorably disposed toward the initial iteration of the new Manager's proposal than was SDCERS' fiduciary counsel. His primary objection was that the weakening of the trigger provision transgressed the intended limits of "corridor funding." In materials provided to the SDCERS Board, Mr. Roeder pointed out:

- On an EAN basis, SDCERS had one of the lowest funded ratios in California;
- The gap between the actuarial rate and the City contribution rate was increasing;
- The SDCERS funded ratio was at its lowest point since the 1980s; and
- At the next evaluation, it was expected to fall further.

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263 *Id.* at 15.

264 *Id.*

265 *Id.* at 16-17.

In a slide, colloquially entitled "Which Way Ya Goin'?," Mr. Roeder illustrated the widening gap between SDCERS' assets and liabilities under two diverging arrows labeled "enhanced benefits" and "contribution relief." Among the listed benefits were enhancements to the pension formula stemming from the 2000 and 2002 labor negotiations. Specified items of contribution relief were: the adoption of the PUC funding method; the resetting of the 30-year amortization period in 1991; the lowered contribution rates under MP1; and the phase-in of certain changes in actuarial assumptions.[266] He provided graphs to illustrate the growing disparity between the City's contributions and the PUC rate and the yet greater disparity between those contributions and the EAN rate.

Mr. Roeder had also voiced criticism of certain aspects of SDCERS' funding situation in his actuarial valuation for the fiscal year ended June 30, 2001, completed in early February 2002 and available to the public as an attachment to the SDCERS CAFR for that year. He referred in particular to the damage to the soundness of the System that could result from the misuse of the concept of surplus earnings:

> We offer comment related to disposition of Surplus Undistributed Earnings. Suppose that the System earns 0% in the current fiscal year and 16% next year. Our understanding is that a contribution to Surplus Undistributed Earnings will be made for the 16% year even though there will be no net gain from investments over the two-year period. If extra benefits are conferred in the "good" years, then the median, "after the fact" investment return to finance all other benefits should theoretically be correspondingly lower. We will revisit this issue in the experience investigation.

In all previous years after the adoption of MP1, the Gabriel Roeder Smith & Co. annual valuations had concluded that the System was, as a general matter, actuarially sound. In the 2001 valuation, however, this language included an added element of caution:

> Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. However, we want all parties to be acutely aware that the current practice of paying less than the computed rate of contribution or pickup will help foster an environment of additional declines in the funding ratios in absence of healthy investment returns.[267]

Also opposed to the amendment to MP1, as initially proposed, was San Diego attorney Michael Aguirre, who, in a letter dated June 20, 2002, threatened the Board and its members with litigation should they approve the proposal as presented. Mr. Aguirre objected to the reduction of

266 In an interview with Vinson & Elkins, Mr. Roeder stated that the assumptions to which he referred involved the reduction in City contribution rates reflecting the fact that certain employees on whose behalf contributions were made would not become vested members of the System. The number of such employees had been overestimated in previous years, causing an excessive discount to the City's contribution rate. Rather than incorporate this in a single upward adjustment to the City's rates, the SDCERS Board had agreed that it would be phased in over a five-year period.

267 2001 Actuarial Valuation, supra note 221, at cmt. M, at 17.

the trigger level and expressed skepticism that the City would honor even the reduced level should it be breached. He opined that the SDCERS Board should follow the advice of its fiduciary counsel, Hanson Bridgett, and reject the proposal. "This advice is based on the most fundamental law of trusts," he wrote, "a trustee shall not dissipate the *res* of the trust."[268]

C. Further iterations of the second Manager's proposal

Given the opposition of its fiduciary counsel and actuary, the Board communicated to the Manager's Office that it would not consider the proposal as it then stood. Mr. Uberuaga and his staff responded with two significant modifications. Rather than retain the MP1 schedule of .50% annual increases in City contributions, the Manager proposed to double the increase to 1% of applicable payroll. The amended proposal further provided that the agreement would sunset in FY 2009, at which time the City would pay the full PUC rate – however much progress it had or had not made toward that goal through seven years of stepped-up contributions. The City's contributions would thereafter continue to increase by .50% a year until the EAN rate was achieved, as under MP1.[269] The second iteration of the new proposal, however, retained the proposed reduction of the funding floor to 75% of the AAL.[270]

At the June 21, 2002 meeting of the SDCERS Board, its actuary acknowledged the improvements made in the revision to the new Manager's proposal, but again pointed out in detail the deterioration in the System's funded status, which was even more pronounced when measured under the EAN method. He indicated as causes of the funding shortfall changes in System demographics, substantial additional benefits and the five years of contribution relief provided by MP1. Under these circumstances, he remained unconvinced that lowering the funding trigger was an appropriate action.

> With the original Manager's Proposal, Mr. Roeder said he had similar misgiving as he has today. However, he was more comfortable with the [original] proposal because of the 82.4% [sic] floor. With that floor, it seemed to provide the necessary prudent protection to the System. However, he is concerned with the new proposal because of the coupling of benefit increases to funding, along with the significant change from the 82.3% safeguard to 75%.[271]

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268 Similarly, *see* Minutes of SDCERS Board Meeting, at 21 (July 11, 2002) (remarks of Mr. Aguirre).

269 Initial ambiguity on this point was addressed by the Manager's Office in: Memorandum from Bruce Herring, Deputy City Manager, to Lawrence Grissom, Retirement Manager, SDCERS, Re: City's Proposal Regarding Contribution Rates and Reserves and Responses to Questions from SDCERS Trustees (July 1, 2002).

270 Memorandum from Michael T. Uberuaga, City Manager, to SDCERS Board. of Administration, Re: June 18, 2002 Modification to the Proposal from the City of San Diego Regarding Employee Contribution Rates, Health Insurance and Reserves (June 18, 2002). *See also* Minutes of SDCERS Board Meeting, at 16-17 (June 21, 2002) (remarks of Mr. Herring).

271 Minutes of SDCERS Board Meeting, at 17- 19 (June 21, 2002).

EXHIBIT 24

DRAFT 6/12/02

June __, 2002

Mr. Lawrence Grissom
Retirement Administrator
San Diego City Employees' Retirement System
401 B Street, Suite 400
San Diego, CA 92101-4227

Re: San Diego City Employees' Retirement System ("SDCERS") – Proposed Amendment to the Manager's Proposal

Dear Larry:

This responds to your letter of May 23, 2002 requesting an opinion on whether or not the Retirement Board's acceptance and approval of the proposal to lower the "floor" in the Manager's Proposal to 75% would be a proper exercise of the Board's fiduciary responsibilities.

Our opinion is set out below and is based on our review of the following:

- The San Diego Municipal Code,
- The Manager's Proposal and accompanying documents provided to us by SDCERS.
- The description provided to us by SDCERS on June 12, 2002 of the proposed amendment to the Manager's Proposal, including a lower "floor" of 75% to trigger additional funding.
- The presentation by the City Manager to the Retirement Board on May 29, 2002 in support of the amendment to the Manager's Proposal.
- Our discussions with Rick Roeder, SDCERS' actuary, and his letter to us of June ___, 2002.
- California and other relevant fiduciary law.

EXHIBIT 61
1-28-04 Hiatt D. Coby
PENGAD 800-631-6989

SDC006385

DRAFT 6/12/02

SUMMARY OF OPINION

Based on the facts as we understand them and as summarized below, and based on the law discussed below, it is our opinion that there is a material risk that a court would find that approval by the Retirement Board of the proposed amendment including the reduction in the "floor" in the Manager's Proposal to 75% was not a prudent exercise of the Board's fiduciary responsibilities, particularly if insufficient mitigating actions were taken by the Board. The facts summarized below are unlikely to be construed as providing the necessary substantial evidence of actuarial soundness to support the proposed change to the Manager's Proposal. Of course, our opinion could be different if the facts are not as we understand them.

The Board may be able to take mitigating actions with respect to the current Manager's Proposal, and some possible actions are discussed below. Any such actions, however, should be based on the exercise of due diligence by the Board, which most likely will take additional time. Generally, the Board's actions with respect to establishing a finding policy must be based on a thorough understanding of the facts, a thorough evaluation and recommendation from SDCERS actuary, and consideration by the Board of the consequences of its actions for the integrity and security of SDCERS funding status.

SUMMARY OF FACTS

We understand the relevant facts to be as follows.

1. The Manager's Proposal

The Manager's Proposal was proposed by the City and adopted by the Retirement Board in 1996. In brief summary, under the Manager's Proposal the following occurred:

a) Certain pension and health benefits were increased for SDCERS retirees and active members.

b) A scheduled set of City contribution rates was adopted by SDCERS through 2009, to provide stability to the City's budget process.

c) The scheduled contribution rates were acknowledged to be lower than the contribution rates that would otherwise have been required under the annual valuation that is conducted annually by SDCERS' actuary.

d) A portion of the cost of the benefit improvements was considered to have been paid from a special "excess earnings" reserve of approximately $105 million.

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e) In 1996, SDCERS assets equaled about 91% of liabilities. In 1997, SDCERS was about 93% funded.

f) A safeguard clause was included in the Manager's Proposal, and was strengthened to protect the funding status of SDCERS at the request of SDCERS fiduciary counsel and actuary. The safeguard provided that if the funding status of SDCERS falls more than 10 percentage points below the then current ratio – that is, falls below 82.3% – in the following year the City would contribute enough to SDCERS to bring the ratio up to 82.3%[1].

g) In 1996, in discussing the Manager's Proposal, Board members expressed concern about the possibility that a balloon contribution payment would be required and it would be difficult for the City to make such a payment. In response, the City Manager said that if SDCERS' funding status were to deteriorate so the difference between the scheduled and actuarial rates were to increase, the city would accelerate the "ramp up" of contributions to avoid having to deal with a balloon payment at the end of the scheduled contribution rates.

2. <u>Current Actuarial and Financial Status of SDCERS</u>

a) Contributions currently being made to SDCERS by the City are 9.83% of payroll. Under the actuarial valuation most recently approved by the Board, the full actuarially computed contribution rate would be 12.58% of payroll or 2.75 percentage points higher. For the fiscal year July 1, 2002 – June 30, 2003, contributions under the Manager's Proposal will be 10.33%; the full actuarial rate will be 15.59%, or 5.26 percentage points higher.

b) The total of City and member contributions to SDCERS are not sufficient to cover both normal cost and interest on past service cost computed at the actuarial funding rate.

c) From July 1, 1996 through June 30, 2002, the difference between what was contributed by the City and what would have been contributed under the amounts computed in accordance with the actuarial valuation plus earnings on the difference, totals about $90 million.

d) As of June 30, 2001, SDCERS' funding ratio was approximately 89.9%.

e) It is estimated that as of June 30, 2002, SDCERS funding ratio will be close to 82.3%.

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[1] For example, if the funding ratio were to fall to 80% as of June 30, 2002, then for the fiscal year July 1, 2003 – June 30, 2004 we understand that, under the current Manager's Proposal, the City would increase the scheduled contribution by an amount that would bring the funding ratio to 82.3%. We also understand that this require an extra contribution in the 2004 fiscal year, above the scheduled contribution, of about $75 million based on current data.

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f) Since July 1, 2000, SDCERS funding ratio has fallen by an estimated 14 percentage points, from approximately 97.3% as of June 30, 2000 to close to an estimated 82.3% as of June 30, 2002.

g) As of June 30, 2002, it is estimated that the SDCERS funding ratio will be the lowest that it has been for the past 14 years. The next lowest ratio, prior to June 30, 2001, was in 1996 at approximately 91%.

h) This change is believed to be due to several factors, including: the fall in the equity markets, the substantial reduction in interest rates due to action by the Federal Reserve Bank, increased liabilities on account of changes such as city employees staying longer on their jobs, and an increase in benefits under the "Corbett" settlement.

i) SDCERS' investment consultant has told SDCERS that there has been a structural change in the capital markets and in the future it is less likely that SDCERS will have earnings in the ranges that were achieved during the prior 10 years. SDCERS investment consultant has also said that earnings will likely be more volatile for the foreseeable future than for the prior ten years.

j) After meeting its other obligations, it is expected that SDCERS will effectively have no "surplus earnings" at the year ending June 30, 2002, to fund new benefits or to make up funding shortfalls.

k) City contributions have not increased over the scheduled amounts in the Manager's Proposal even though there have been benefit increases under SDCERS since the adoption of that Proposal, most notably the benefits provided under the "Corbett" settlement.

l) We understand that liabilities under the Corbett settlement are included in the SDCERS actuarial valuation for active employees only and not for retirees. This treatment affects contribution rates and the funding ratio of SDCERS. If these liabilities for retirees were included in the actuarial valuation, we understand that the funding ratio for SDCERS would be approximately 2.5 percentage points lower or 87.4% funded as of June 30, 2001.

m) GASB has approved six standard actuarial funding methods for pension expensing purposes[2]. These methods require current funding of "normal" cost plus level amortization over a stated period of years of past service liabilities. SDCERS actuary has informed us of one other California public retirement system that uses a funding method with a safeguard trigger similar to that under the Manager's Proposal, however the trigger point for that system is a 90% funding ratio.

[2] We understand that pension expensing is not necessarily the same as pension funding.

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n) In 1996, SDCERS actuary was satisfied that the Manager's Proposal met actuarial standards. An important reason for that opinion was that the City had committed to meet all of the conditions in the Proposal including the safeguard floor and trigger. SDCERS actuary has informed us that he is not satisfied with the proposed amendment, to a substantial extent because of the proposed change to the safeguard floor.

Mr. Rick Roeder, in his letter to us of June __, 2002, has confirmed the above items (a) through (h) and (j) through (n). You have confirmed item (i) to us.

3. <u>Proposed Amendment to the Manager's Proposal</u>

Under the proposed amendment to the Manager's Proposal, we understand that the following would occur:

a) The safeguard trigger for increasing the City contributions will be reduced from a funding ratio of 82.3% to a funding ratio of 75%.

b) If the funding ratio goes below 75%, the City would not commit to making up the gap between the floor funding ratio of 75% and the actual funding ratio. Instead, the City would commit to increase its contribution rate on July 1 of the following year by "an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent four years in order to achieve the full actuarial rate over a five year period."

c) The proposed amendment does not deal with a number of issues, such as the following:

- What is the "full actuarial rate"? Is it the PUC rate or the EAN rate?
- If the full actuarial rate increases in later years because of, e.g., benefit increases, will the "difference" to which the 20% is applied also increase, or is this a fixed amount?
- If the full actuarial rate increases because of changes in actuarial method and/or assumptions, will the new rate be the full actuarial rate for this calculation[3]?
- What happens if the funding ratio goes down again in a later year? Will a new 20% amount be calculated and contributed?

[3] Paragraph C of the Manager's Proposal under the heading "Issue No. 3 – Employer Contribution Rates" is unclear on this point.

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- When will the City's contribution bring SDCERS funding ratio to the 75% floor? When will it bring the ratio to the current 82.3% floor?

- What is the anticipated course of events over the next, e.g., five years given the known status of SDCERS liabilities and asset values and anticipated earnings over the next few years?

d) The City has not proposed to take any mitigating action to strengthen the funding status of SDCERS, such as increasing its scheduled contributions under the Manager's Proposal. Further, the City has not proposed to take any mitigating action to assure SDCERS that if the funding ratio falls below 75% that it will not again request a reduction in the "trigger" to strengthen SDCERS' funding status, and will be able to pay and will pay the amounts required.

e) The benefit formula for general members of SDCERS would be increased but a benefit cap would be imposed (with appropriate grandfathering).

f) To reflect the benefit increases stated in the paragraph above, City contributions would increase effective July 1, 2003, in addition to the scheduled increase under the existing Manager's Proposal. We understand that this increase would cover both the added normal cost and amortization of the past service cost from the increase in general members' benefits. General member contributions would also increase, but payment would be as stated in the following paragraph.

g) The City would pick up certain employee contribution increases for all SDCERS members. However, these amounts would be paid from the existing Employee Contribution Rate Reserve of SDCERS until that Reserve is exhausted.

h) City contributions otherwise will continue to be made on the schedule established by the Manager's Proposal.

i) The City Manager has stated to the Retirement Board that the City is making this proposal to have "reasonable flexibility" in making contributions to SDCERS. Further, he said that this proposal is a part of the City's agreements with the labor unions, and the City's desire to have three year agreements. Moreover, he stated that this proposal allows the City to plan out the next three years. Further, he stated that the City's financial concern "really will be the fiscal year 2004" because of possible shortfalls in revenues from the State in that year.

j) The proposed amendment to the Manager's Proposal also includes a request that SDCERS approve the creation of a section 115 trust for retiree health insurance and authorize the "transfer" of $25 million from FY 2000 earnings to that trust as soon as practical. The

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proposal does not comment on the effect that this would have on the SDCERS funding ratio nor on City contribution rates. It appears from the proposed amendment, however, that the City does not expect that it would make any additional contribution to SDCERS if such a "transfer" occurred.

ANALYSIS

1. <u>Current Situation Compared to the 1996 Manager's Proposal</u>

One of the key questions that has been asked is: what is the difference between 2002 and 1996, with respect to the safeguard "floor"? In other terms, if 82.3% was an appropriate floor in 1996, why not 75% today? To a substantial extent, the fiduciary decision of the Board must be based on current facts, as they relate to the Board's fiduciary duty to act prudently and exclusively in the interest of plan participants. Relevant current facts as we understand them, and as they contrast to the facts in 1996, are set out below. Further below, we discuss the law as it applies here.

There are significant differences in several areas, including the following:

- SDCERS actuarial and financial status is different. In this regard, SDCERS actuary's view of the proposed amendment is substantially different than his view of the Manager's Proposal.

- The original structure of the Manager's Proposal has been tested and it does not appear to work as intended, particularly with regard to the safeguard floor. Further, the proposed amendment could leave SDCERS less well funded than the current structure.

- Viewing the City as a "borrower", as the Board did in 1996, the City is requesting more favorable terms even though its "debt" is greater than in 1996 and the original deal objective was not reached.

- There have been new developments in the law.

Each of these areas is discussed below.

a. <u>The Actuarial and Financial Situation is Different</u>

Below are set out material actuarial and financial differences from those existing in 1996.

- SDCERS funding status has fallen by an estimated 14 percentage points in the last two years, and is the lowest in 14 years. It is estimated to be approximately 8 percentage points below

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the funding ratio in 1996. The contributions under the Manager's Proposal are less than the actuarially determined contribution rates under the annual actuarial valuation. The contributions under the Manager's Proposal (including member contributions) do not cover normal cost plus interest on past service liabilities[4].

- SDCERS will have little, if any, net surplus earnings at the end of the 2002 fiscal year, in comparison to the $105 million available in 1996.
- The City has not increased its contribution rates over those in the Manager's Proposal to take account of the increased benefits due under the Corbett settlement, and the portion of that settlement relating to retirees is not included as a liability in the actuarial valuation.
- SDCERS actuary is not satisfied with the proposed amendment to the Manager's Proposal because a key part of that Proposal was the safeguard that the City proposes to amend.
- SDCERS investment consultant forecasts the likelihood of lower and more volatile earnings in the future than in the past 10 years.
- The City is concerned that its financial situation will get worse in the coming years.
- Under the proposed amendment, the City will not promise to make up any shortfall below the trigger in one year or even in five years. Instead, the City proposes to increase its contribution rate. However, there are a number of questions about the City's proposal (set out above). Depending on how they are answered and depending on the particular circumstances, this increase in contribution rate could provide less or more funding to SDCERS if the "trigger" ratio were hit.
- SDCERS current funding integrity and security has been adversely impacted by application of the Manager's Proposal.

Please note that we can only comment on the facts that we have as of the date of this letter. Any additional facts available to the Board should be examined when it considers the issue.

b. <u>The Original Structure of the Manager's Proposal Does Not Appear to Work</u>

Two key parts of the Manager's Proposal are relevant to the current issue: establishing a safeguard floor that would be implemented, and avoiding a balloon payment that could cause problems for the City.

[4] If ~~you were to~~ this were view this in terms of paying off a mortgage, the principal amount of the mortgage debt would be increasing because interest on the debt is not being covered. Under pre-ERISA tax law, this could call into question the qualified status of SDCERS.

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With respect to the safeguard floor, this was strengthened at the request of SDCERS fiduciary counsel and actuary to ensure that if the funding ratio went below the floor, there would be immediate action to restore SDCERS funding status. See Minutes of SDCERS' Retirement Board Special Workshop of June 11, 1996, p. 19 and compare the Manager's Proposal dated June 7, 1996 to the Manager's Proposal dated June 21, 1996; see also Dwight Hamilton letter to Lawrence Grissom of September 19, 1996, page 3. Nevertheless, the efficacy of the safeguard trigger as a means of protecting the funding soundness of SDCERS must be questioned because the City has requested that this safeguard be substantially reduced or substantially diluted.

With respect to avoiding a balloon payment, at the Board meeting of June 21, 1996, several Board members raised concerns about whether the Manager's Proposal would be setting-up a situation where the City might have to make a balloon payment that could not be met. The City Manager stated that he also was concerned about a balloon payment and that the City would "ramp up" its contributions above the rates required in the Manager's Proposal if it appeared that would occur. Nevertheless, it appears that one of the reasons for the proposed amendment is the City's concern that a substantial additional payment could soon be required under the Manager's Proposal and the City has not "ramped up" its contributions as anticipated in 1996.

In light of the current proposed amendment to the Manager's Proposal, it appears that neither of these key structural elements of the Proposal works. The safeguard floor is not a safeguard precisely because the City has asked that it be lowered. Further, it appears that an important reason that the City has asked that it be lowered is that, under the existing structure, a substantial balloon payment may be required in the next three years, when the City wants stability for its budget.

c. The City's Status as a "Borrower" May Be Influenced by Actions Taken After 1996

When the Board considered the Manager's Proposal, the Board viewed the City as a borrower and evaluated the likelihood that the City would in fact pay its obligation to SDCERS as agreed to under that Proposal. At the time, given the facts available, the Board's evaluation was that this obligation would be paid.

However, in light of the current proposed amendment to the Manager's Proposal, it appears that the City's position as a borrower from SDCERS is not as strong as in 1996. This is precisely because the City has stated that it wishes not to meet its obligations under that Proposal, and instead wishes to renegotiate the agreement, or debt (which is now a greater amount) to alleviate financial hardship for the City. Such actions indicate the City's unwillingness or inability to budget in advance for anticipated obligations to SDCERS under the Manager's Proposal. Such actions at least raise questions about "borrower's", or the City's, commitment to pay the contributions as promised in the Manager's Proposal, or in an amendment to such agreement. In

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light of the change in the funding status of SDCERS, the Board arguably must place greater weight on this issue since the "debt" is much larger.

Please note several facts. First, the City is not only asking that the safeguard floor be lowered to 75%; it is also asking that if the funding ratio goes below the floor that it would not have to contribute enough to bring the funding ratio up to the floor in any stated period of time. Second, the City is already the beneficiary – in calculating the funding ratio – of the exclusion of the Corbett retiree liabilities. Third, the City has stated that it expects its financial status to be weaker in 2003-2004. Fourth, the City has not provided any additional security to support payment of its obligations under the proposed amendment.

d. New Legal Developments-Since 1996

The legal issues are discussed below.

2. Rules that Govern the Board's Actions

The members of the Board must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." California Constitution, Article XVI, Section 17. It also must act to minimize employer contributions, but its duty to participants and beneficiaries "shall take precedence over any other duty." Id.

Generally, prudent action requires that all relevant facts be examined and evaluated before a decision is made. See Sacher, "Employee Benefits Law, 2nd Ed." at 666 (2000). In obtaining these facts, the Board should use its expert advisors, such as its actuary and investment consultant. Further, of course, the ultimate decision made by the Board must bear a proper relation to the goal of the retirement system to provide secure benefits to its members and beneficiaries.

In this regard, the California courts have stated several times that a key element of the operation of a retirement system as SDCERS is to ensure the financial integrity and security of the system. See *Valdes* v. *Cory*, 139 Cal.App.3d 773 (1983), 785; *Claypool* v. *Wilson*, 4 Cal.App.4th 646, 671, 672 (1992); *Board of Administration* v. *Wilson*, 52 Cal.App.4th 1109, 1134, 1136 (1997). To ensure financial integrity and security, the Municipal Code requires that the City contribute to SDCERS the amount that is determined by the actuary's annual actuarial valuation, and requires amortization of past service liabilities over no more than 30 years[5]. This is similar to the statutory funding premise in *Wilson*, above. See 52 Cal.App.4th at 1122.

[5] The Municipal Code (section 24.0801) requires that the City make contributions to SDCERS as follows:

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Financial integrity and security are issues of fact. See e.g., *Wilson*, 52 Cal.App.4th at 1139, *Claypool*, 4 Cal.App.4th at 672, fn 7. Therefore, in making a decision with respect to the proposed amendment to the Manager's Proposal, the Board should gather and examine all relevant facts, obtain the advice of its actuary and investment advisor, and evaluate the proposal in relation to the requirement to maintain the financial integrity and security of SDCERS. A court would likely review any decision by the Board to see if there was substantial actuarial evidence to support the Board's decision. *Wilson*, 52 Cal.App.4th at 1139.

In reviewing the duty of a retirement plan board, one court noted that the primary duty of a board is owed to its participants and the constitutional mandate is to place the needs of participants above all others and thus ~~the~~ ensure the financial integrity of the assets placed in its care. *Corcoran v. Contra Costa County Employees' Retirement Board*, 60 Cal.App.4th 89, 94 (1997).

We have set out above the facts available to us as of the date of this letter. If additional facts and expert advice become available to the Board, these also should be considered by the Board in making its decision.

> Commencing July 1, 1954 the City shall contribute to the Retirement Fund in respect to members a percentage of earnable compensation as determined by the System's Actuary pursuant to the annual actuarial evaluation required by Section 24.0901. The required City contributions shall be determined separately by the Actuary for General Members and Safety Members.
>
> All deficiencies which may accrue as a result of the adoption of any section in the Retirement Ordinances must be amortized over a period of thirty years or less. Any amount designated pursuant to Section 24.1203(b)(5) shall not constitute a deficiency within the meaning of this section.

Section 24.0901 provides the following:

> The Board shall keep in convenient form such date [sic] as is necessary for the actuarial evaluation of this system as of June 30, 1954, and thereafter at the end of periods not to exceed one year it shall cause to be made an actuarial valuation of the assets and liabilities of the system, and at periods of not to exceed five years said Board shall cause to be made a thorough actuarial investigation of the mortality, service and compensation experience of members and persons receiving benefits, together with an actuarial valuation of the assets and liabilities of the system.

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3. What Funding Ratio is the Appropriate "Trigger"?

There is a substantial basis for concluding that the "floor" or "trigger" funding ratio is the incorrect focus with respect to determining the City's contributions to SDCERS. This is the case for several reasons, discussed below.

First, the funding ratio will vary substantially based on different factors. In this regard, the City controls the benefit levels that are promised under SDCERS. But critical factors that affect the funding ratio are outside anyone's control, including the economy, the capital markets, the Federal Reserve Bank, and the employment and retirement decisions of SDCERS members. The funding ratio will vary with all of these. Therefore, if the Board wants to provide the City with predictable contribution rates, the funding ratio is an inappropriate basis for setting a funding policy. Additionally, such a method does not secure scheduled contributions that are connected to the costs of benefits accrued for City employees in any given year (i.e. this method fails to connect the City's cost of contributions to services rendered by employees in a year).

Second, as can be seen in the present situation, if a funding ratio is the trigger for the funding obligation, there is a substantial chance that the trigger will be hit in situations when the economy is not doing well. As now, such a situation provides temptation for the City to request additional alleviation of its funding obligations through a lower trigger. Whatever good current intentions the City may have, if a "floor" would trigger a balloon payment, there is a substantial chance that the City will return again to SDCERS for another lowering of the floor. The very fact that the City Manager stated the City's good intentions in 1996, and the City's inability to act to meet those intentions now, is evidence that this situation can recur.

Third, to the extent that we know of benchmarks that are used to measure adequacy of funding for various purposes, they probably are inappropriate for the current fact situation. For example, here are some funding ratio benchmarks:

125% funding – used under the federal tax law to determine when there is sufficient funding to divert funds from a retirement system.

99% funding – funding ratio under ERISA used to determine when additional contributions must be made to certain private sector plans.

90% funding – used as a contribution "trigger" for one other large California public sector retirement system.

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There are other questions similar to what is the appropriate funding ratio for a trigger. For example, if the Board approved 82.3% in 1996, could it have approved 75% in 1996? And if it could have done so, what is the problem with moving to 75% in 2002?

There is a reasonable basis to conclude that the Board could have approved a 75% trigger in 1996[6], based on the facts in effect at that time, if there were also a favorable report from the Board's actuary. However, the facts have changed, as discussed above, and any decision of the Board in 2002 must be prudent based on the facts (and the law) available to it now. As discussed above, the current facts and the opinion of the Board's actuary do not appear to support further reliance on a funding ratio trigger, much less reduce it.

Furthermore, the proposed amendment would not only reduce the floor trigger, but would also further delay City contributions. Moreover, depending on the circumstances, under the proposed amendment it could be many years before SDCERS funding ratio was 75% under the proposed amendment.

Again, the focus of a funding ratio trigger may be inappropriate. The courts have made it clear that an actuarially sound, annual contribution is the key element in providing for the integrity and soundness of a retirement fund. See *Wilson*, 52 Cal. App. 4th at 1134 - 1135, citing *California Teachers Assn.v. Cory*[7]

4. <u>Financial Integrity and Soundness is Established With Regular, Annual Contributions</u>

In 1996, the relevant court decisions were *Valdes, supra* and *Claypool, supra*. Both of these decisions discussed the vested right of public retirement system members to a retirement program that is soundly funded, actuarially. *Valdes* at 785; *Claypool* at 672, fn7. Thereafter, the Court of Appeal had the opportunity to again review a situation where the employer wished to avoid its then current contribution obligation. *Wilson, supra*. In this case, the court thoroughly reviewed the obligation of an employer to fund a retirement system on an actuarially sound basis. The words of the court – and the quotations that it took from experts who provided evidence to it – substantially strengthened the law with respect to funding. Here is what the *Wilson* court said, in part

- "There is a vested right to 'integrity and security of the course of funding for the payment of benefits.' "52 Cal.App.4th at 1136, quoting from Valdes, 139 Cal.App.3d at 785.

[6] In fact, there was a short discussion at the June 11, 1996 Board Workshop of a 77.3% trigger (15% below the then funding ratio). However, this was not approved and there seemed to be no desire on the part of any Board member to adopt that ratio.

[7] In *California Teachers Association v. Cory*, the court noted that the disruption of annual installments of reserves for normal cost is an invasion of the trust's reserve that impairs the employee's right to sound funding. *See* 155 Cal.App.3d 494, 507, 508 (3rd Dist. 1984).

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- "The willingness and ability of the sponsor of a defined benefit pension plan to maintain this 'orderly schedule' [of contributions well in advance of benefit requirements] is the major factor in the assurance of benefit security for retirees. . . ." 52 Cal.App.4th 1139 quoting from the declaration of the PERS actuary.

- "Underpinning both the normal cost calculation and the amortization of the unfunded accrued actuarial liability is an explicit assumption concerning timing of contributions. The importance of timing stems from the fact that a large portion of a member's benefit is funded by the investment earnings which are generated by the plan contributions. When monies are contributed later than expected, reduced earnings result—thus creating a shortfall." 52 Cal.App. 4th at 1140, quoting from the declaration of the PERS actuary.

The Municipal Code itself recognizes the need for financial soundness by granting the Retirement Board the duty and responsibility to set contributions pursuant to the annual actuarial evaluation. Section 24.0801.

The courts' conclusions are supported by other guidance. For example, the Government Finance Officers Association has said that public officials should do the following: "Assure that actuarially required contributions are collected by the pension plan on a timely basis. Reductions in or postponement of contributions violates one of the basic principles of level percent-of-payroll financing and constitutes a real threat to responsible funding." GFOA Statement of Recommended Practices for public pension plans, recommendation 3 concerning funding.

It appears that there is a substantial disconnect between these rules and the proposed amendment to the Manager's Proposal, as follows:

- Contributions currently are less than the rate recommended under the actuarial valuation, though this was approved because of the safeguard floor. However, the safeguard would be reduced under the proposed amendment.

- Currently, the funding status of SDCERS has been adversely affected by contributions under the Manager's Proposal, but this was approved because of the safeguard floor. However the safeguard would be reduced under the proposed amendment.

- The City has not made any proposal to currently, positively and materially affect the funding status of SDCERS with a reduction in the safeguard floor.

- The City's status as a "borrower" from SDCERS appears to be diminished from its status in 1996 precisely because it is proposing a reduction in the safeguard floor without any offsetting action that would increase SDCERS' funding integrity and security.

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- SDCERS actuary was satisfied that the Manager's Proposal met professional actuarial standards, largely because of the safeguard floor. However, he is not satisfied with the proposed amendment to a substantial extent because the original safeguard floor is not being met and the facts underlying the assumptions have changed.

5. Possible Mitigation.

Several of the court decisions cited above dealt with integrity of funding in the context of "vested rights". *Valdes, supra; Claypool, supra;* and *Wilson, supra.* In this respect, the courts have indicated that the impairment of the vested right to a soundly funded retirement system can be mitigated by providing comparable new benefits that offset the impairment. While this governs with respect to the impairment of contract doctrine and may limit the City's ability to act, it is not governing with respect to the Board's responsibility to act prudently. If it were governing, then each time that employer persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. That would not pass elementary actuarial requirements. Instead, as set out in the Municipal Code, whenever benefits are increased they should be paid for in accordance with standard actuarial practice, so normal cost is paid currently and past service costs amortized over an appropriate number of years – which is no more than 30 years under the Municipal Code.

However, there are possible mitigating actions that the Board might wish to consider in this situation. Such actions would be based on the principle that the integrity and soundness of a retirement system requires current contributions on a level basis to cover both normal cost and past service liability. For example, the Board might wish to consider a lower "trigger" point if there were material increases in the City's scheduled contributions, so the funding level of SDCERS is substantially strengthened on a current basis. Also, the Board might wish to ensure that all benefits increases that occur in the future, and that have occurred since 1996, are funded in accordance with section 24.0801 of the Municipal Code, which requires the contribution of normal cost plus 30 year amortization of past service liabilities. (The City could agree that no further amendment to the Manager's Proposal will be proposed or made for a set number of years, except to increase the City's contribution.)

Any such actions, however, should be based on the exercise of thorough due diligence by the Board, which most likely will take additional time. Generally, the Board's actions with respect to establishing a funding policy must be based on a thorough understanding of the facts, a thorough evaluation and recommendation from SDCERS actuary, and consideration by the Board of the consequences of its actions for the integrity and security of SDCERS funding status.

6. Role of Retirement Board

As it evaluates the facts and makes its fiduciary decision, the Board may wish to consider clearly defining its role with respect to the funding of SDCERS.

Under the proposal, benefits increases are "conditioned" on the Board accepting the proposed amendment to the Manager's Proposal. We are concerned that this puts the Retirement Board into the middle of the bargaining and benefit determination process. But the proper role of the Retirement Board is to set the contribution rate for the City and its employees and to administer the program that is established by the City, the plan sponsor. It is appropriate for the Retirement Board to establish clear and actuarially sound principles that it will adhere to with respect to contributions to SDCERS[8]. It is also quite appropriate for the Board to periodically restate these principles so the parties that negotiate benefits know exactly where they stand in respect to the cost of any negotiations. Further, within reason, it is appropriate for the Board to offer the opinion of its actuary as to the effect on contribution rates of particular alternative benefit formulas that are being considered by the City.

However, it is inappropriate for the City to put the Board into the position of essentially accepting or rejecting a particular benefit structure by accepting or rejecting a particular modification to the City's contribution requirements. This puts the Board into the middle of benefit determination and suggests that sound actuarial principles should be modified to accommodate benefit increases. Neither decision is within the role of the Board. In fact, if the Board is put in this position, then the bargaining parties would be basing benefit improvements on a condition that is within the control of an independent third party, the Retirement Board. Further, the Board must act solely in the interests of participants and an act to protect the City from difficult budget issues is arguably not in furtherance of the Board's fiduciary duty.

7. Risk

Under the facts as we understand them, and for the reasons discussed above, it is our opinion that there is a material risk that if the Board were to agree to the proposed amendment to the Manager's Proposal in its current form, and if this decision were challenged in court, a court would hold that the decision was not a proper exercise of the Board's fiduciary responsibilities based upon the facts before the Board and the actuaries opinion to the contrary. A court would look at whether the Board had substantial evidence to support the propriety of its actions and there is a material risk that a court would find such evidence lacking.

The remedies that might be ordered by a court in such a situation are difficult to predict and depend on the nature of any challenges presented to the court. The response to possible

[8] Such principles, of course, could, to some extent, take into account current emergency financial situations that the City might face. A secondary duty under the California Constitution is to minimize employer contributions. Cal. Const. Art. XVI, Section 17(b).

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challenges could include some or all of the following: ordering the Board to reconsider its decision: ordering members of the Board who were directly involved in the bargaining process to recuse themselves from any reconsidered decision; ordering the permanent removal from the Board of some or all of its members; ordering the City to contribute to SDCERS under the terms of the original Manager's Proposal plus contributing lost earnings on that amount; imposing personal liability on each member of the Board who voted to approve the proposed amendment; and imposing personal liability on each member of the Board.

* * * * * * * * * *

Please call the undersigned if you have any questions about this letter.

Very truly yours.

Constance M. Hiatt

Robert Blum

EXHIBIT 25

REPORT ON INVESTIGATION

The City of San Diego, California's

Disclosures of Obligation to Fund the

San Diego City Employee's Retirement System

and Related Disclosure Practices

1996-2004

with

Recommended Procedures and Changes to the Municipal Code

September 16, 2004

Paul S. Maco
Richard C. Sauer
Vinson & Elkins L.L.P.
Washington, D.C.

... provided the Board with a history of the System and discussed realized gains. He reported that the System has historically utilized earnings as a means to pay certain benefits within the System. However, the Board is now faced with a situation where the projected earnings for this fiscal year are far short of what they have been over the past ten years. He reported that the System's high mark was in June of 1999, when the System achieved $468 million in realized earnings. This year, Staff projects the earnings will be somewhere between $40 million and $50 million.[254]

During the spring of 2002, the City concluded labor negotiations with three of its municipal unions. In the meet and confer process, the City agreed to increase the basic multiplier for retirement benefits for general employees to 2.5% at age 55. Combined with the increase from 2.0 to 2.25% from the FY 2000 negotiations, this meant that the cost of the basic retirement benefit would increase 25% over a two-year period. Labor and management also agreed that the City Manager would propose to the SDCERS Board that it transfer $25 million from surplus earnings into a reserve to fund the healthcare benefit in future years in which earnings were insufficient for this purpose.

These new benefits were explicitly contingent upon the willingness of the SDCERS Board to grant the City additional breathing room with respect to the MP1 funding floor. Specifically, for the benefits to be implemented, the Board was required to lower the trigger level from 82.3% to 75% of actuarial assets. In the event that the new floor was breached, furthermore, the City would have five years to ramp up to the full actuarial rate. Although in other contexts it attributed the need for these concessions primarily to investment losses,[255] in its communications with the municipal unions, the Manager's Office emphasized the cost of pension benefits previously granted as necessitating the proposed modification of the trigger provision. In a "Summary of the City's Final Position" sent to its municipal unions on May 9, 2002, the City stated:

> Substantial benefit improvements granted by the City since the adoption of the "City Manager's Retirement Proposal" dated July 23, 1996 (Manager's Proposal) have created additional unfunded liability to SDCERS that was not anticipated when the City agreed to the "trigger" provisions. Significant improvements in benefits are contained in this three-year proposal. Consequently, the "trigger" provisions must be adjusted as a condition of the City's three-year proposal[;] therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of

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abrupt changes in asset levels and, consequently, volatile contribution rates. Because the years that were about to fall out of this calculation had provided strong returns, the burden on the next years would be that much greater. At the time the Board was considering the second Manager's proposal, the market value of System assets trailed their actuarial value by approximately $230 million. *Id.* at 18 (remarks of Mr. Roeder).

[254] Minutes of SDCERS Special Board Meeting, at 1 (May 29, 2002).

[255] Memorandum from Cathy Lexin and Elmer Heap to Mayor and City Council (June 14, 2002), *supra*; and Memorandum from P. Lamont Ewell, Assistant City Manager, City of San Diego, to Mayor and City Council, Re: San Diego City Employees' Retirement System Benefit Enhancements (Dec. 6, 2002).

Trustees of an adjustment to the "trigger" provisions contained in the Manager's Proposal.[256]

Thus, the Board was again placed in a position of being forced to veto benefit enhancements to System members should it decide the contribution relief that came attached to these benefits unacceptably threatened SDCERS' financial soundness. This came at a time when the Board was increasingly concerned about the City's failure to pay for benefits granted to SDCERS members. The role played by SDCERS reserves in the growing gap between assets and liabilities was explicitly recognized. At a May 29, 2002, meeting of the Board, its president stated:

> one of the other things that was called into question was whether it was a breach of the Board's fiduciary duty if the Board were to take money from the reserve accounts and move them outside plan assets for contingent benefits or other purposes that didn't provide the funding of the benefits that the System is inherently responsible for paying.[257]

Mr. Vortmann, by this time a member of the SDCERS Board, expanded on this theme. After noting with approval the Board's efforts to formalize the status of certain contingent benefits, he commented:

> However, the Board must constantly reconcile [this effort] to the Board's primary mission to insure [sic] there are adequate assets to pay off all the future benefits to both current retirees and current employees when they become retired. The Board needs to assure that the Board is getting the plan sponsor to contribute adequate cash to the Plan the Board administers. For several years now, the Board has been approving an actuarial report that has in its wording: the funding objective of the retirement system is to establish and receive contributions expressed as a percent of active member payroll which will remain approximately level from year to year and will not have to be increased for future generations of citizens. The Board adopts this each year but doesn't follow it. Every effort the fund has to pay a contingent benefit creates a bigger departure from achieving that funding objective. He stated he doesn't begrudge anybody any benefits. However, he is very concerned that for various reasons the Board has continued to create a situation where the City is not paying to the trustees of this Board the cost that the City is incurring each year. The City is purposely pushing out onto future taxpayer's payments for services they are incurring today.[258]

On the same day, Michael Uberuaga, who had succeeded Mr. McGrory as City Manager, appeared before the SDCERS Board and stated that the City intended to seek a modification to

[256] Memorandum entitled "City of San Diego Police Offices Association" (May 9, 2002) at 1.

[257] Minutes of SDCERS Special Board Meeting, at 6 (May 29, 2002) (remarks of Mr. Pierce).

[258] *Id.* at 20-21 (remarks of Mr. Vortmann).

EXHIBIT 26

CALIFORNIA CODES
GOVERNMENT CODE
1091. (a) An officer shall not be deemed to be interested in a contract entered into by a body or board of which the officer is a member within the meaning of this article if the officer has only a remote interest in the contract and if the fact of that interest is disclosed to the body or board of which the officer is a member and noted in its official records, and thereafter the body or board authorizes, approves, or ratifies the contract in good faith by a vote of its membership sufficient for the purpose without counting the vote or votes of the officer or member with the remote interest.

(b) As used in this article, "remote interest" means any of the following:

(1) That of an officer or employee of a nonprofit entity exempt from taxation pursuant to Section 501(c)(3) of the Internal Revenue **Code** (26 U.S.C. Sec. 501(c)(3)) or a nonprofit corporation, except as provided in paragraph (8) of subdivision (a) of Section **1091**.5.

(2) That of an employee or agent of the contracting party, if the contracting party has 10 or more other employees and if the officer was an employee or agent of that contracting party for at least three years prior to the officer initially accepting his or her office and the officer owns less than 3 percent of the shares of stock of the contracting party; and the employee or agent is not an officer or director of the contracting party and did not directly participate in formulating the bid of the contracting party.

For purposes of this paragraph, time of employment with the contracting party by the officer shall be counted in computing the three-year period specified in this paragraph even though the contracting party has been converted from one form of business organization to a different form of business organization within three years of the initial taking of office by the officer. Time of employment in that case shall be counted only if, after the transfer or change in organization, the real or ultimate ownership of the contracting party is the same or substantially similar to that which existed before the transfer or change in organization. For purposes of this paragraph, stockholders, bondholders, partners, or other persons holding an interest in the contracting party are regarded as having the "real or ultimate ownership" of the contracting party.

(3) That of an employee or agent of the contracting party, if all of the following conditions are met:

(A) The agency of which the person is an officer is a local public agency located in a county with a population of less than 4,000,000.

(B) The contract is competitively bid and is not for personal services.

(C) The employee or agent is not in a primary management capacity with the contracting party, is not an officer or director of the contracting party, and holds no ownership interest in the contracting party.

(D) The contracting party has 10 or more other employees.

(E) The employee or agent did not directly participate in formulating the bid of the contracting party.

(F) The contracting party is the lowest responsible bidder.

(4) That of a parent in the earnings of his or her minor child for personal services.

(5) That of a landlord or tenant of the contracting party.

(6) That of an attorney of the contracting party or that of an owner, officer, employee, or agent of a firm that renders, or has rendered, service to the contracting party in the capacity of stockbroker, insurance agent, insurance broker, real estate agent, or real estate broker, if these individuals have not received and will not receive remuneration, consideration, or a commission as a result of the contract and if these individuals have an ownership interest of 10 percent or more in the law practice or firm, stock brokerage firm, insurance firm, or real estate firm.

(7) That of a member of a nonprofit corporation formed under the Food and Agricultural **Code** or a nonprofit corporation formed under the Corporations **Code** for the sole purpose of engaging in the merchandising of agricultural products or the supplying of water.

(8) That of a supplier of goods or services when those goods or services have been supplied to the contracting party by the officer for at least five years prior to his or her election or appointment to office.

(9) That of a person subject to the provisions of Section 1090 in any contract or agreement entered into pursuant to the provisions of the California Land Conservation Act of 1965.

(10) Except as provided in subdivision (b) of Section **1091**.5, that of a director of or a person having an ownership interest of 10 percent or more in a bank, bank holding company, or savings and loan association with which a party to the contract has a relationship of borrower or depositor, debtor or creditor.

(11) That of an engineer, geologist, or architect employed by a consulting engineering or architectural firm. This paragraph applies only to an employee of a consulting firm who does not serve in a primary management capacity, and does not apply to an officer or director of a consulting firm.

(12) That of an elected officer otherwise subject to Section 1090, in any housing assistance payment contract entered into pursuant to Section 8 of the United States Housing Act of 1937 (42 U.S.C. Sec. 1437f) as amended, provided that the housing assistance payment contract was in existence before Section 1090 became applicable to the officer and will be renewed or extended only as to the existing tenant, or, in a jurisdiction in which the rental vacancy rate is less than 5 percent, as to new tenants in a unit previously under a Section 8 contract. This section applies to any person who became a public official on or after November 1, 1986.

(13) That of a person receiving salary, per diem, or reimbursement for expenses from a **government** entity.

(14) That of a person owning less than 3 percent of the shares of a contracting party that is a for-profit corporation, provided that the ownership of the shares derived from the person's employment with that corporation.

(c) This section is not applicable to any officer interested in a contract who influences or attempts to influence another member of the body or board of which he or she is a member to enter into the contract.

(d) The willful failure of an officer to disclose the fact of his or her interest in a contract pursuant to this section is punishable as provided in Section 1097.. That violation does not void the contract unless the contracting party had knowledge of the fact of the remote interest of the officer at the time the contract was executed.

EXHIBIT 27

CALIFORNIA CODES
GOVERNMENT CODE

87100. No public official at any level of state or local **government** shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.

EXHIBIT 28

CITY OF SAN DIEGO MUNICIPAL CODE / Chapter 2 Government / Article 7: Elections, Campaign Finance and Lobbying / Division 35: City of San Diego Ethics Ordinance / §27.3560 Financial Interest in Contract

§27.3560 Financial Interest in Contract

(a) It is unlawful for any *City Official* to be financially interested in any contract made by them in their official capacity.

(b) It is unlawful for any contract to be made by the *City* Council or any board or commission established by the *City* Council if any individual member of the body has a financial interest in the contract.

(c) For purposes of the prohibitions set forth above in subsections (a) and (b), the term financial interest means any interest, other than a remote interest as prescribed in California Government Code section 1091 or a non-interest prescribed in California Government Code section 1091.5, which would prevent the *City Officials* involved from exercising absolute loyalty and undivided allegiance to the best interests of the *City*.

(d) Any *City Official* with a remote interest in a prospective contract of the *City* must disclose the existence of the remote interest to the body of the board which the *City Official* is a member if that board has any role in creating, negotiating, reviewing, or approving the contract; and the *City Official* must abstain from influencing or participating in the creation, negotiation, review, or approval of the contract.

("Financial Interest in Contract" added 4-29-2002 by O-19055 N.S.)

EXHIBIT 29

2. NON OPT OUT CLASS AND NOTICE OF SETTLEMENT.

a. Because the form of relief being provided by this settlement is in the nature of primary equitable relief for alleged actions that are generally applicable to the entire Settlement Class, the parties have agreed to settle in the manner of a "Federal Rule 23(b)(2)" settlement, which does not require that members of the Settlement Class receive notice of the class certification and the opportunity to opt out of the Settlement Class. This provision is an integral component of this Settlement.

b. After the Court tentatively approves this Settlement, SDCERS shall mail notice of the proposed Settlement to the Settlement Class, notifying members of the Settlement Class of their right to object to the settlement (the "Class Settlement Notice").

3. SETTLEMENT CONSIDERATION.

In consideration of the release set forth below in Section 4 and the other promises made herein, the Parties agree as follows:

a. The City's Annual Contributions For Fiscal Years 2006 through 2008, and Security for Performance of Charter Obligations

Under the provisions of Article IX, Section 143 of the City Charter of the City of San Diego (the "Charter"), the City is obligated to contribute for fiscal years 2006 through 2008 to SDCERS an amount derived from the rates calculated by the actuary for SDCERS in its annual valuation and approved by the SDCERS Board of Administration (the "Contribution Amount"). The City acknowledges its Charter obligation to pay the Contribution Amount for fiscal years 2006 through 2008. Such obligations are expressly limited to future fiscal years 2006 and beyond, and do not in any way create a Charter obligation to pay any amount greater than the City has already contributed to SDCERS for any fiscal year prior to 2006. Payment of the Contribution Amounts described below are in full satisfaction of the City's Charter obligations for each fiscal year.

In addition to the terms set forth below, the City agrees to provide collateral to secure payment of the annual contribution obligation through FiscalYear 2008.

Commencing with the June 30, 2004 Annual Actuarial Valuation, the amortization period for the Unfunded Actuarial Accrued Liability ("UAAL") will be reset to a new 29-year fixed amortization period. The City's Contribution Amount for Fiscal Years 2006, 2007 and 2008 only (the "Period"), will be based on the 29-year fixed amortization period reset as of the June 30, 2004 Annual Actuarial Valuation (i.e., the FY 06 Contribution Amount will be calculated based on year 29 of a 30 year fixed amortization period, the FY 07 Contribution Amount will be calculated based on year 28 of a 30 year fixed amortization period, and the FY 08 Contribution Amount will be calculated based on year 27 of a 30 year fixed amortization period). After Fiscal Year 2008, subject to any amendment to the Charter, the City will remain obligated pursuant to the Charter to contribute to SDCERS an amount derived from the rates calculated by the SDCERS actuary in its annual valuation and approved by the SDCERS Board of Administration, and SDCERS may utilize any amortization schedule it chooses, consistent with Article XVI, section 17, of the California Constitution and may implement any new, different, or modified actuarial assumptions, and /or funding methods, in consultation with its actuary, for purposes of establishing the City's annual employer contribution thereafter. The parties acknowledge that amortization schedules selected by SDCERS after Fiscal Year 2008 may be considerably shorter than 30 years, in which event there will be a substantial increase in the City's contribution amount. In calculating the contribution rates for the Period, the actuary will use the assumptions and PUC funding method included in the experience evaluation adopted by the SDCERS Board at its February 2003 meeting.

For the purposes of this Agreement only, the Contribution Amount shall be exclusive of the payments of employee contributions paid by the City, if any, employer contributions to DROP, and any other additional contributions paid by the City on behalf of its employees.

It is the parties' intent to herewith provide for certain collateral to secure performance of the City's Contribution Amount through SDCERS' Fiscal Year 2008. The collateral will consist of real property owned by the City unencumbered (except by leases, easements or deed restrictions) and having fair market value (using the methods described in this paragraph) of at least $125,000,000.00 for each of SDCERS' Fiscal Years 2006, 2007 and 2008, to secure performance of the City's Charter obligation to pay the Contribution Amount for these fiscal years, for a total collateral amount of at least $375,000,000.00. The City shall select the collateral that will be used to secure payment of the Contribution Amount. The value of the collateral will be based on the property's Highest and Best Private Use determined by Limited Appraisal and Restricted Use Reports (the "Reports") in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"), which Reports the City has provided to SDCERS. The City heretofore has provided SDCERS with legal descriptions, assessor's plat maps, current preliminary title reports, and a Limited Use Appraisal and Restricted Use Report for the parcels comprising the collateral. The parties hereto have accepted each of the City's parcels described in Exhibit B hereto as the collateral described above.

The Reports (described below) contain the Limited Use Appraised value of certain City properties and, thus the parties recognize that others may seek to obtain or use the Reports for entrepreneurial purposes not in the best interests of the City or its taxpayers. It is expressly agreed that the Reports only state certain values for the purpose of this settlement, and for no other reason whatsoever. The Reports and all drafts of such Reports shall remain strictly confidential. Subject to the exceptions noted below in this paragraph for SDCERS, no party or their agents, employees, attorneys or appraisers shall release or disclose the Reports or the content of the Report unless compelled to do so by lawful subpoena or court order. The Reports are comprised of two documents: (i) a Report concerning collateral for Fiscal Year 2006 and 2008 ("Report A"); and (ii) a Report concerning collateral for Fiscal Year 2007 ("Report B"). SDCERS may release (i) Report A to other third parties only when reasonably necessary to respond to inquiries or assertions concerning the value of the collateral for Fiscal Years 2006 and/or 2008; and (ii) Report B only in response to lawful subpoena or court order.

(1) Fiscal Year 2006 Payment

To secure payment on or before July 1, 2005 of the Contribution Amount for Fiscal Year 2006, the City will execute, acknowledge, record and deliver to SDCERS, within 20 days of the Court's entry of a judgment approving the Agreement, a Deed of Trust in form and content as set forth on Exhibit D attached hereto and incorporated herein by reference (there being no Exhibit C). Within 20 calendar days after payment of the contribution amount for Fiscal Year 2006, SDCERS will execute and deliver to the trustee under the Exhibit D Deed of Trust a request for full reconveyance thereof.

(2) Fiscal Year 2007 Payment

To secure payment on or before July 3, 2006 of the Contribution Amount for Fiscal Year 2007, City will execute, acknowledge, record and deliver to SDCERS, within 20 days of the Court's entry of a judgment approving the Agreement, a Deed of Trust in form and content as set forth on Exhibit E attached hereto and incorporated herein by reference. Within 20 calendar days after payment of the contribution amount for Fiscal Year 2007, SDCERS will execute and deliver to the trustee under the Exhibit E Deed of Trust a request for full reconveyance thereof.

(3) Fiscal Year 2008 Payment

To secure payment on or before July 2, 2007 of the Contribution Amount for Fiscal Year 2008, the City will execute, acknowledge, record and deliver to SDCERS, within 20 days of the Court's entry of a judgment approving the Agreement, a Deed of Trust in form and content as set forth on Exhibit F attached hereto and incorporated herein by reference. Within 20 calendar days after payment of the contribution amount for Fiscal Year 2008, SDCERS will execute and deliver to the trustee under the Exhibit F Deed of Trust a request for full reconveyance thereof.

(4) Substitution of Collateral

(A) Conditional right to substitute collateral

So long as City is not in default under any of its obligations to pay the Contribution Amounts specified above, or otherwise under the provisions of any of the four Deeds of Trust given to secure performance of those obligations, the City may, subject to the provisions and conditions set forth below, elect to substitute collateral held by SDCERS as security for payment of any Fiscal Year's Contribution Amount.

(B) Substitution procedure

If, at any time prior to July 1, 2007, City desires to make such a substitution of collateral, City shall deliver to SDCERS' Retirement Administrator a Deed of Trust ("Replacement Deed of Trust") which is identical in form and content to that of the Deed of Trust encumbering the collateral to be replaced ("Replaced Deed of Trust"), except that the Replacement Deed of Trust shall be dated currently and shall describe real property including or consisting of real property ("Replacement Collateral") different than that described in the Replaced Deed of Trust ("Replaced Collateral"). Any request for substitution of collateral as described in this paragraph shall be published in SDCERS' regular monthly meeting agenda and all information pertaining to the substitution request shall be publicly announced by SDCERS at the next meeting as an agenda item.

(C) Requests for reconveyance of Replaced Deed of Trust

SDCERS shall not unreasonably decline to request a full reconveyance of the Replaced Deed of trust, it being understood that a refusal to request a full reconveyance will be deemed reasonable only if the Replacement Collateral is encumbered (by other than leases, easements or deed restrictions) or has a fair market value of less than that of the Replaced Collateral, or both. The determination as to whether the Replacement Collateral is encumbered (by other than leases, easements or deed restrictions) or has a fair market value less than that of the Replaced Collateral shall be made, on behalf of SDCERS, by its Retirement Administrator utilizing values current as of the date on which the Replacement Deed of Trust is delivered. In the event SDCERS'

Retirement Administrator determines that the Replacement Collateral both is unencumbered (by other than leases, easements or deed restrictions) and has a fair market value equal to or greater than that of the Replaced Collateral, SDCERS shall request a full reconveyance of the Replaced Deed of Trust immediately upon recordation and delivery to SDCERS of the Replacement Deed of Trust

(D) <u>Resolution of disputes pertaining to reconveyance of Replaced Deed of Trust</u>

In the event City disagrees with any determination by SDCERS' Retirement Administrator that the Replacement Collateral is either encumbered (by other than leases, easements or deed restrictions) or has a fair market value less than that of the Replaced Collateral, the matter will be submitted to a retired San Diego Superior Court Judge jointly selected by the parties for binding arbitration to be conducted pursuant to the provisions of Part III, Title 9 of the California Code of Civil Procedure, with each party bearing its own attorneys' fees and costs. In the event the arbitrator determines that the Replacement Collateral both is unencumbered (by other than leases, easements or deed restrictions) and has a fair market value equal to or greater than that of the Replaced Collateral, SDCERS shall request a full reconveyance of the Replaced Deed of Trust immediately upon recordation and delivery to SDCERS of the Replacement Deed of Trust. In the event the arbitrator determines either that the Replacement Collateral is encumbered (by other than leases, easements or deed restrictions) or that it has a fair market value less than that of the Replaced Collateral, SDCERS shall not be required to request a full reconveyance of the Replaced Deed of Trust.

(5) <u>Foreclosure on Collateral</u>

The Deeds of Trust, and the obligations they secure, are not cross-collateralized; accordingly, SDCERS may foreclose under a Deed of Trust only in the event the City fails to timely pay the full Contribution Amount for the particular fiscal year mentioned in the Deed of Trust, and only to the extent of the failed payment(s) due and owing at that time.

SDCERS acknowledges it has no right to receive rents or profits generated by the real property comprising the collateral absent default in the payment secured by any deed of trust containing an assignment of rents and profits.

b. Termination of Prior Contribution Agreements.

Upon final approval of this Agreement by the Court, the contribution agreements between the City and SDCERS known as Manager's Proposal I and Manager's Proposal II shall terminate, and be of no further force or effect.

c. Repeal of Portions of San Diego Municipal Code Section 24.0801

Within 120 days of the Court's entry of a final order approving the Agreement, the City shall repeal those portions of San Diego Municipal Code Section 24.0801 enacted November 18, 2002 which specify that rates the City pays are as agreed to in the governing Memorandum of Understanding between the City and SDCERS. The City may enact other lawful enabling ordinances as appropriate so long as such ordinances are not inconsistent with this Agreement or the Charter.

d. SDCERS' Legal Opinion.

Prior to execution of this Agreement, SDCERS will (a) have obtained an opinion from a lawyer that the security instruments and collateral securing the City's Contribution Amount described above comply with all applicable laws, including Article VII, Section 99 of the Charter; and (ii) that the security will be a valid and enforceable security obligation and duly perfected security interest, or (b) will have certified that SDCERS is unable to obtain an opinion on those subjects. The City shall pay the actual cost of obtaining the opinion (up to $100,000.00 and no more, billed separately from any other opinions). However SDCERS' inability to obtain an opinion on the subjects shall not be a condition in any respect to this Settlement Agreement.

e. Stipulated Non Opt Out Settlement Class.

All parties stipulate to class certification of a "non opt out" class for purposes of settlement only. The settlement embodied herein applies to all members of the class in *Gleason*,

EXHIBIT 30

GABRIEL, ROEDER, SMITH & COMPANY
Consultants & Actuaries
9171 Towne Centre Drive • Suite 440 • San Diego, California 92122 • 858-535-1300 • FAX 858-535-1415

February 4, 2005 CONFIDENTIAL

Ms. Debra Berger
City Attorney's Office
San Diego, CA 9201

Mr. Bruce Herring
City Manager's Office
San Diego, CA 92101

Dear Debra and Bruce,

At the request of SDCERS, we are providing you some of the information relating to cost requests that were made last week.

We have designated requests made by the City manager's Office as ("CM"). Requests initiated by the City Attorney's Office are designated as ("CA"). Numbering pertains to the request lists submitted by the two offices.

Unless indicated otherwise, all percents are applied to active member payroll. DROP members are not considered part of active member payroll. Unless indicated otherwise, the assumptions and benefits used are consistent with those used to determine computed rates in the 2004 actuarial valuation report.

In our financial projections, we are using the following amortization periods:

FYE	Years
2007	28
2008	27
2009+	15

<u>Due to the one-year contribution lag, FYE 2007 will correspond to the June 30, 2005 valuation.</u> Where we show June 30 dates, the unfunded liability ("UAL") and the funded ratio will be shown as of that date without reflecting any "lag."

All contribution dollar amounts, in tables, will be shown as millions.

#11aCM (" Contingent Corbett"). Analyze impact of including Corbett contingent benefits in liabilities.

If the 7% allowances to a designated class of retirants and deferred vested members, as of June 30, 2000, is explicitly included in the June 30, 2004 actuarial valuation, we estimate the following impacts:

Increase in contribution rate	+0.66% (up to 27.52% from 26.86%)
Increase in accrued liability	$63 million
New funded ratio	64.7% (65.8% in valuation)
Estimated increase in FY06 contribution	$3.8 million

GRS is on record as favoring explicit recognition of this liability in the valuation.

CM also asked what the impact of the following alternate treatment would be if "contingent" Corbett were instead to be paid directly from City funds for FY05: $5.6 million

#6CA and #5CM. Eliminate DROP. The biggest cost impact attributable to DROP is the change in retirement age selection caused by DROP. In the valuation, we treat a DROP member as equivalent to a retiree currently in pay status. A major problem: we cannot isolate the impact of DROP in this regard. Thus, the impact of DROP is unknowable due to other significant factors (ie, multiple changes in benefit formulas and 90% benefit cap) also potentially impacting changes in retirement incidence since DROP implementation.

However, since that very true answer is likely to be unsatisfactory to various parties, we have made a very rough guesstimate that the total present value of benefits might increase for a participant in DROP by 2-3% relative to a non-DROP scenario. However, some of the increase in the DROP could arguably be attributed to the benefit cap.

If a member hits the 90% cap, the member will usually have little incentive not to DROP. Is the added cost here due to the DROP or to the presence of the 90% cap? It really is a combination of the two factors. This figure is inclusive of the 3.05% contribution made by the City. Such contribution is not part of the computed rate we calculate in the actuarial valuation report.

The only reason that we are attempting this guesstimate is to give parties some initial idea as to general magnitude.

For the eight plan years, since DROP inception, ending on June 30, 2004, retirants were classified as follows:

Service Retirants	708	(30%)
DROP	1,378	(58%)
Disability	284	(12%)
Total	2,370	(100%)

Our "high end" guesstimate is based on the following assumptions:

3% average increase in the present value (and, therefore, also in the accrued liability) of a benefit due to DROP

60% probability of a future retiree going into DROP

After elimination of DROP, the City would be willing to pay the 3.05% DROP monies directly to SDCERS to help pay down the unfunded liability.

This assumes that all accrued liability increase is attributed to DROP and not to other factors such as the 90% cap. This, we see this analysis as being at the "high end" of a debatable range.

If DROP were eliminated in 2007, prior to June 30, the first year of fiscal impact would be FYE2009.

Scenario #1 High End of Guesstimated Financial Impact

June 30	UAL Reduction	Contribution Decrease FYE		Funded Ratio Increase
2009	$62	0.73%	$4.8	0.7%
2013	74	0.84	6.5	0.5
2018	93	0.84	8.0	0.3

This "high end" assumes a significant one-shot increase in liability for FYE 2009. In practice, this will only happen if the Retirement Board elects to change retirement assumptions pursuant to our experience investigation study this spring.

At the low end of the guesstimate range, we believe DROP costs no less than the 3.05% City contribution to DROP accounts each year. As of June 30, 2004, annualized DROP allowances were $41.9 million. In FYE2004, the City's contributions on behalf of DROP members were $1.57 million.

Scenario #2 Low End of Guesstimated Financial Impact

June 30	UAL Reduction	Contribution Decrease FYE		Funded Ratio Increase
2009	$ 6	0.02%	$ 0.1	0.1%
2013	15	0.12	1.0	0.1
2018	29	0.22	2.1	0.2

Our best professional judgment is that the impact of DROP is somewhere in the middle of the two Scenarios. This judgment may change after this spring's Experience Investigation is completed.

If DROP is eliminated, active member payroll will increase. This will have differing impacts on the normal cost and amortization calculations.

#11b CM. Estimate the amount of additional monies would be needed as of 7/1/05 to achieve a funded ratio of 85% and 90%:

For 85%: $837 million contributed as of July 1, 2005.

For 90%: $1.058 billion contributed as of July 1, 2005.

Estimate the added contribution, made both at 7/1/05 and 7/1/06, to achieve a funded ratio of 85% and 90% as of 7/1/06:

For 85%: $413 million contributed both at July 1, 2005 and July 1, 2006.

For 90%: $529 million contributed both at July 1, 2005 and July 1, 2006.

Estimate the added contribution, made at 7/1/05 and 7/1/06 and 7/1/07, to achieve a funded ratio of 85% and 90% as of 7/1/07:

For 85%: $272 million contributed on all three dates.

For 90%: $353 million contributed on all three dates

#4b CM. The City will maintain existing contributions for pickup. Employee pick ups will be reduced by 2.5% and 5%, respectively, as of July 1, 2005. There would be no immediate impact on unfunded accrued liability ("UAL"). However, the City would apply such payments to pay down the UAL.

Scenario #1: 2.5% Pick Up Reductions

June 30	UAL Reduction	Contribution Decrease	FYE	Funded Ratio Increase
2006	16	0 %	$ 0	0.3%
2007	34	0	0	0.6
2008	53	0.16	1.0	0.9
2010	90	0.72	4.9	1.3
2015	194	1.67	14.1	1.8

Scenario #2: 5% Pick Up Reductions

June 30	UAL Reduction	Contribution Decrease	FYE	Funded Ratio Increase
2006	32	0 %	$ 0	0.5%
2007	67	0	0	1.2
2008	105	0.32	2.0	1.8
2010	181	1.44	9.8	2.6
2015	387	3.35	28.1	3.7

We have assumed that 2% of the increase in out-of-pocket employee contributions will ultimately be paid out in refund.

#1CA. Reduce current benefit multiplier for active employees only by 0.25% per year of benefit service accrual while keeping other benefit option multipliers intact. Certain benefit formulas were "grandfathered" prior to subsequent benefit changes. For completeness, we have done this analysis with and without the 90% benefit cap. This cap was put in for Safety at the same time DROP was created. The 90% cap for General employees occurred more recently.

For this purpose, we assumed the change occurred as of the June 30, 2004 valuation date.

Scenario #1: Maintenance of 90% Cap

Decrease in contribution rate	Normal Cost	-0.86%
	Amortization	-0.70%
	Total	-1.56%
Decrease in accrued liability	$72 million	
New funded ratio	67.0%	(65.8% in valuation)
Estimated decrease in FY06 contribution	$9.0 million	

Scenario #2: Elimination of 90% Cap

Decrease in contribution rate	Normal Cost	-0.76%
	Amortization	-0.59%
	Total	-1.35%
Decrease in accrued liability	$61 million	
New funded ratio	66.8%	(65.8% in valuation)
Estimated decrease in FY06 contribution	$7.8 million	

#2CA. Reduce current benefit multiplier for active employees only by 0.50% per year of benefit service accrual while keeping other "grandfathered" benefit option multipliers intact.

This will produce the same cost as the 0.25% study due to the grandfathered benefit options.

Today, we were also asked by the City Attorney's office to calculate the impact if the "grandfathered" options were eliminated by both multiplier reductions. We will shortly finish this study.

#7 CA and #11aCM (13th check). Impact of funding "13th check" or eliminating "13th check as of 7/1/2005.

We have assumed that the City portion of the 13th check will be roughly $3.9 million for FYE2004. This amount has been very stable in recent years with total payout increases typically in the 3% area per annum.

There would be no immediate impact on the UAL. We would have evaluated the financial impact as follows:

June 30	UAL Reduction	Contribution Decrease	FYE	Funded Ratio Increase
2010	29	0.27%	$1.8	0.4
2015	55	0.50	4.2	0.5

#11dCM. Evaluate impact of changing amortization period from closed 30-year financing to 15 years. This addresses a change in amortization period changes from 27 years for FYE2008 to 15 years in FYE2009.
As a result, there would be a significant increase in the City contribution.

In this analysis, as in others, the City contribution excludes both DROP and pick up contributions, unless specifically addressed.

Projected 2008 City contribution: $184 million
Projected 2009 City contribution: $245 million

If there was a 26-year amortization period for FYE2009, the projected City contribution would be $196 million.

#5CA and #10CM. Rate structure to ensure cost neutrality of service purchase program. The new rate structure adopted by SDCERS in 2003 will greatly reduce the level of subsidy after June 30, 2005. By such date, SDCERS staff has indicated that processing will be complete for the large number of applications before the former rate structure was changed.

Sincerely,

Rick A. Roeder, EA, FSA, MAAA

#5CA and #10CM. Rate structure to ensure cost neutrality of service purchase program. The new rate structure adopted by SDCERS in 2003 will greatly reduce the level of subsidy after June 30, 2005. By such date, SDCERS staff has indicated that processing will be complete for the large number of applications before the former rate structure was changed.

Sincerely,

Rick Roeder

Rick A. Roeder, EA, FSA, MAAA